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U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

WRITTEN COMMENTS

ON

H.R. 2636

THE TECHNICAL CORRECTIONS ACT OF 1987

A BILL TO MAKE TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986, AND FOR OTHER PURPOSES

VOLUME III

Comments on Title XII Through Title XVIII of the Tax Reform Act of 1986

Comments on Other Laws in the Technical Corrections Act of 1987

JUNE 9, 1988

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FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 10, 1987

PRESS RELEASE #12
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE INTRODUCTION OF H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced introduction of H.R. 2636, the Technical Corrections Act of 1987, which would make technical corrections to the Tax Reform Act of 1986 and other tax legislation enacted during the 99th Congress.

In introducing the bill, Chairman Rostenkowski stated, "Whenever legislation as large and comprehensive as last year's Tax Reform Act is passed by Congress, some mistakes must be expected in drafting under such extreme time pressures. Clearly, last year's statute is not drafted with technical accuracy in every respect. Unfortunately, a resolution directing the enrolling clerk to correct certain errors and omissions in the legislation (H. Con. Res. 395), was not passed prior to adjournment of the 99th Congress. Therefore, Senator Lloyd M. Bentsen (D., Texas), Chairman of the Senate Committee on Finance, and I instructed our staffs to work together with all the tax-writing staffs of the Congress and the Treasury Department to review the Tax Reform Act of 1986 and make recommendations for technical corrections and clarifications to that legislation. The staff has recently completed its work, and the bill that the Honorable John J. Duncan, Ranking Republican Member of the Committee, and I are introducing today includes necessary technical changes to last year's landmark legislation."

BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. This legislation is cosponsored by the Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, and the Honorable John J. Duncan (R., Tennessee), Ranking Republican Member of the Committee on Ways and Means. The Honorable Lloyd M. Bentsen (D., Texas) is introducing an identical bill in the Senate today, cosponsored by the Honorable Bob Packwood (R., Oregon), Ranking Republican Member of the Senate Finance Committee.

In order to assist those interested in the legislation to understand its contents, the staff of the Joint Committee on Taxation will issue a pamphlet in the near future explaining the provisions of the legislation. The Joint Committee print will be available for sale to the general public. It can be obtained at the GPO bookstore or by calling the Superintendent of Documents at (202) 275-3030 and referring to Description of the Technical Corrections Act of 1987, Jacket no. 73-917.

WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of this legislation should submit six (6) copies of their written comments by the close of business, Friday, July 10, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FOR IMMEDIATE RELEASE
MONDAY, JULY 6, 1987

PRESS RELEASE #15
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES ANNOUNCES AN EXTENSION OF THE PERIOD FOR SUBMITTING WRITTEN COMMENTS ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee has extended, until Friday, July 17, 1987, the time period for submitting written comments to H.R. 2636, the Technical Corrections Act of 1987.

In announcing the extension, Chairman Rostenkowski stated, "I am pleased that many interested members of the public have written the Committee commenting upon H.R. 2636, the Technical Corrections Act of 1987, in response to the Committee's press release dated June 10, 1987. These comments will be very helpful to the Members of the Committee and the staff when the Committee acts on this legislation. Due to the Committee's reconciliation schedule which precludes a public hearing, I am announcing an extension of the date for submission of written comments on H.R. 2636 until July 17, 1987."

BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. By press release dated June 10, 1987 (see press release #12), the public was invited to submit written comments on this legislation on or before July 10, 1987. This press release extends the time for filing comments until close of business on July 17, 1987.

WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of H.R. 2636, the Technical Corrections Act of 1987 should submit six (6) copies of thier written comments by the close of business, Friday, July 17, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

CONTENTS

["Title" and "Section" refer to the "Tax Reform Act of 1986," unless otherwise indicated.[*] Comments are arranged alphabetically by Title and Section]

Page
Volume I (Titles I-VI of the Tax Reform Act of 1986) 1-638
Volume II (Titles VII-XI of the Tax Reform Act of 1986) 639-1154
Volume III (Titles XII-XVIII of the Tax Reform Act of 1986; comments on other laws in the Technical Corrections Act of 1986) 1155-1860

Press releases of Wednesday, June 10, and Monday, July 6, 1987, announcing request for written comments III

The following alphabetical listing contains comments covering more than one Title of the Tax Reform Act of 1986:

American Bankers Association, statement and attachment (Sections 643, 701, 903, 1205, 1214 and 1805) 1
American Bankers Association, Trust Division, Richard B. Covey, letter and attachment (Sections 131, 806, 1132, 1402, 1431 and 1433) 9
American Bar Association, Section of Real Property, Probate and Trust Law, Jerry J. McCoy, letter forwarding comments of individual members of the Committee on Tax Legislation and Regulations; Income Taxation of Trust and Estates (Sections 132, 501, 511, 1401, 1402, and 1404) 17
American Bar Association, Section of Taxation, John B. Jones, Jr., letter forwarding comments of individual members of the Committee on Estate and Gift Taxes; Committees on General Income Tax Problems and Real Estate Tax Problems; Committee on Natural Resources; Committees on Real Estate Tax Problems and U.S. Activities of Foreigners and Tax Treaties; Committees on Real Estate Tax Problems and Low Income Taxpayer Problems; Committee on Real Estate Tax Problems; and Committee on Regulated Investment Companies (Sections 105, 107, 252, 311, 413, 511, 701, 811, 1810, and IRC Sections 851-855 and 4982) 23
American Bar Association, Section of Taxation, Charles W. Hall, letter forwarding comments of individual members of the Committee on Sales and Financial Transactions; REMIC Task Force; Committee on Banking and Savings Institutions; Committee on Foreign Activities of U.S. Taxpayers; and Committee on Estate and Gift Taxes (Sections 860, 901, 903, 1201, 1211, 1215, 1221, and IRC Section 2035) 74
American Bar Association, Section of Taxation, Charles W. Hall, letter forwarding comments prepared and reviewed by individual members of the Committees on S Corporations, Professional Service Corporations, Natural Resources, Tax Accounting Problems and Government Submissions (Sections 632, 633, 803, 806 and TCA Section 119) 125
American Camping Association, Armand B. Ball, letter (Sections 1012 and 1431) 136
American College of Probate Counsel, Estate and Gift tax Committee, and Employee Benefits in Estate Planning Committee, statement (Sections 113, 1172, 1431, 1433, and IRC Sections 3035-2038) 137
American College of Probate Counsel, Fiduciary Income Tax Committee, statement (Sections 132, 5411, 1402, 1404, and IRC Section 642) 146

---

[*] IRC=Internal Revenue Code; TCA=H.R. 2636, The Technical Corrections Act of 1987.

Page
American Council of Life Insurance, statement (Sections 701, 1011 and 1151) ... 151
American Farm Bureau Federation, John C. Datt, letter (Sections 404 and 1161) ... 158
American Insurance Association, C. Michael Gilliland, letter and attachment (Sections 1023, 1221, and IRC Section 6655) ... 160
Beaver College, Glenside, Pa., Bette E. Landman, letter (Sections 123, 1012 and 1123) ... 166
Cadillac Products, Inc., Sterling Heights, Mich., Albert H. Giuliani, statement (Sections 201, 204, 211 and 902) ... 168
California League of Savings Institutions, W. Dean Cannon, Jr., statement (Sections 901 and 503) ... 172
Chamber of Commerce of the United States, David G. Koenig, letter (Sections 201, 701, 1201, 1221, 1211 and 1235) ... 174
Church Alliance, Gary S. Nash, statement (Sections 1012, 1107, 1120 and 1881) ... 178
Citicorp, statement (Sections 671–675, 902, 1201, 214, 1221 and 1261) ... 180
Cohen, Kenneth, S., Shaker Heights, Ohio, letter and attachments (Sections 211, 501, 701, 1122, 1411, and IRC Section 86) ... 190
Columbia University, New York, N.Y., Gregory Fusco, letter (Sections 123, 1012 and 1107) ... 196
Committee of Banking Institutions on Taxation, Albert G. Doumar, letter and attachment (Sections 132, 301, 701, 806 and 1403) ... 198
Coopers & Lybrand, David T. Wright, statement (Sections 201, 211, 501, 621, 1809 and 1841) ... 202
E.I. DuPont de Nemours & Co., William Resnick, letter (Sections 1201, 1222 and 1165) ... 206
Emergency Committee for American Trade, Robert L. McNeill, letter and attachment (Sections 201, 701, 803, 1201, 1221 and 1261) ... 207
Gekas, Hon. George W., a Representative in Congress from the State of Pennsylvania, statement (Sections 141, 806 and 1122) ... 214
Government Finance Officers Association, Catherine L. Spain, statement (Sections 1107, 1121 and 1301) ... 216
Gunnar, Peter M., Lake Oswego, Oreg., letter (Sections 501 and 1532) ... 221
Illinois State Bar Association, Donald C. Schiller, letter and attachment, forwarded by Hon. Harris W. Fawell, a Representative in Congress from the State of Illinois (Titles I, V, VI, VII, XI, XIV, XV and XVIII) ... 223
International Council of Shopping Centers, Wallace R. Woodbury, statement (Sections 501 and 812) ... 226
Lafayette College, Easton, Pa., David W. Ellis, letter (Sections 1012 and 1107) .. 229
Lake, F. David, Jr., and R. Scott Kilgore, Wilmer, Cutler & Pickering, letter and attachment (Sections 211, 701, and IRC Section 38) ... 230
National Associations of Home Builders, statement (Sections 252, 501, 502, 522 and 824) ... 242
National Association of Wheat Growers, James W. Miller, letter (Sections 141, 202, 211, 213, 403, 404, 405 and 701) ... 247
National Council of Savings Institutions, statement (Sections 503, 621 and 901) ... 249
National Grange, Mark C. Nestlen, statement (Sections 141, 201, 403, 404, 501, 701, 801 and 1161) ... 252
National Telephone Cooperative Association, statement (Sections 701 and 1116) ... 257
National Tooling & Machining Association, statement (Sections 201, 302, 321, 501, 511 and 804) ... 261
Peabody Place, Memphis, Tenn., statement and attachment (Sections 204 and 1317) ... 263
Puerto Rico, U.S.A. Foundation, Carl A. Nordberg, Jr., letter (Sections 701, 1215 and 1231) ... 265
Rockhurst College, Kansas City, Mo., Rev. Robert F. Weiss, S.J., statement (Sections 123, 1012 and 1116) ... 269
Texas Savings & Loan League, Tom S. King, letter (Sections 901 and 503) ... 271
Tulane University, New Orleans, La., Francis L. Lawrence, letter (Sections 123, 1012 and 1116) ... 272
United States League of Savings Institutions, statement (Sections 503, 621, 901, 903 and 904) ... 274
Vanderbilt University, Nashville, Tenn., Jeff Carr, letter (Sections 1012 and 1116) ... 279

TITLE I—INDIVIDUAL INCOME TAX PROVISIONS

Section 102:

Page
Seidman & Seidman/BDO, Mario P. Borini, letter ... 281
Stuart, R. Josephs, San Diego, Calif., letter ... 282

Section 123:

United States Information Agency, Mark Blitz, Associate Director, Bureau of Educational and Cultural Affairs, letter and attachments ... 383
American-Mideast Educational & Training Services, Inc., Orin D. Parker, letter ... 296
American Council of Learned Societies, Stanley N. Katz, letter ... 298
Council for International Exchange of Scholars, Cassandra A. Pyle, John Jonas, and Kathleen M. Nilles, joint statement ... 299
Council of Graduate Schools in the U.S., Jules B. LaPidus, letter ... 306
Guarini, Hon. Frank J., a Representative in Congress from the State of New Jersey ... 308
Institute of International Education:
  Richard W. Dye, letter ... 309
  Frank J. Utecht, letter ... 310
John Motley Morehead Foundation, Russell M. Robinson II, statement ... 314
Liaison Group for International Educational Exchange, Norman Peterson, statement ... 317
Midwestern Universities Alliance, Newton O. Cattell, letter ... 321
National Association for Foreign Student Affairs, Joseph Mestenhauser, letter and attachments ... 322
University of Arkansas, Fayetteville, Ark., Daniel E. Ferritor, letter ... 328

Letters similar to the above were received from—

Ball State University, Muncie, Ind., David L. Wheeler, Dean, Graduate School and Research.
College of Saint Rose, Albany, N.Y., Sister Marquerite E. Donovan, Chair, Business Adminstration/Economics Division.
Dartmouth College, Hanover, N.H., P. Bruce Pipes, Dean of Graduate Study.
Drew University, Madison, N.J., Merrill M. Skaggs, Dean, Graduate School.
Fairleigh Dickinson University, Hackensack, N.J., Barbara Kellerman, Dean of Graduate Studies and Research.
Georgian Court College, Lakewood, N.J., Sister Barbara Williams, President.
Jackson State University, Jackson, Miss., Leslie Burl McLemore, Professor of Political Science, and Dean of Graduate Studies and Research Administration.
Oregon State University, Corvallis, Ore., Lyle D. Calvin, Dean, Graduate School.
Pace University, Pleasantville/Briarcliff Campus, N.Y., Charles D. Masiello, Chairperson, University Committee on Graduate Studies.
St. Bonaventure University, St. Bonaventure, N.Y., Carol B. Diminnie, Dean, School of Graduate Studies.
State University of New York at Buffalo, illiam C. Barba, Assistant Vice Provost.
Texas Christian University, Fort Worth, Tex., John N. Mangieri, Dean of Graduate Studies and Research.
University of California, San Diego, Richard Attiyeh, Dean, Graduate Studies and Research.
University of Miami, Fla., Pamela A. Ferguson, Dean of the Graduate School and Associate Provost.
University of Missouri, St. Louis, Mo., Thomas E. Jordan, Associate Vice Chancellor, and Dean, Graduate School.
University of San Diego, Calif., Edward F. DeRoche, Dean, School of Education.
University of South Carolina, Columbia, S.C., Jeffrey S. Arpan, Director, International Business Programs.
University of Utah, Salt Lake City, Utah, B. Gale Dick, Dean, Graduate School.
University of Washington, Seattle, Wash., Gene L. Woodruff, Dean and Vice Provost for Research.

Page
Virginia Commonwealth University, Richmond, Va., John H. McGrath, Dean, School of Graduate Studies.
Western Illinois University, Macomb, Ill., Suzanne Reid, Dean, School of Graduate Studies.
Western Michigan University, Kalamazoo, Mich., Laurel Grotzinger, Dean, Graduate College.

Section 132:

Evans, Daniel B., Dilworth, Paxson, Kalish & Kauffman, Philadelphia, Pa., letter ... 330
Guth, Mr. and Mrs. Paul L., Pinellas Park, Fla., letter ... 332
Investment Company Institute, statement and attachments ... 333
Saxton, Hon. H. James, a Representative in Congress from the State of New Jersey, forwarding letter and attachment from George Korradi, Vincentown, N.J ... 343

Section 135:

Oberstar, Hon. James L., a Representative in Congress from the State of Minnesota, statement and attachment ... 348

Section 142:

Coalition of Maritime Companies and Associations, Jack M. Park, statement ... 352
Employee Relocation Council, Phillip D. Morris, letter ... 358
National Association of Royalty Owners, Inc., statement ... 360
Shaw, Hon. E. Clay, a Representative in Congress from the State of Florida, forwarding letter from Gerald Farmer, Hvide Shipping, Inc., Fort Lauderdale, Fla ... 362

Title II—Provisions Relating to Capital Cost

Section 201:

Tolley, B. Carry, III, Hunton & Williams, letter ... 364

Section 203:

American Association of Equipment Lessors, Michael J. Fleming, letter and attachment ... 365
Resorts International, Inc., John Antholis, and Walter J. Rockler, joint letter ... 367
Tolley, B. Cary, III, Hunton & Williams, letter ... 369

Section 204:

Chrysler Corp., John J. Salmon, letter ... 371
Dulles Access Rapid Transit Corp., Ben E. Benjamin, letter ... 373
Frenzel, Hon. Bill, a Representative in Congress from the State of Minnesota, letter enclosing statement of Potlach Corp ... 375
Harlingen, Tex., City of, Waterworks System, Brendan Hall, letter ... 376
Horizon Air Industries, Inc., Marshall S. Sinick, statement ... 377
Joint Maritime Congress, Bruce J. Carlton, letter and attachments ... 379
Marine Transport Lines, Inc., Michael C. Berkowitz, statement and attachment ... 385
Moakley, Hon. John Joseph, a Representative in Congress from the State of Massachusetts, letter and attachments ... 393
Mt. Poso Cogeneration Project, Donald C. Alexander Bechtel Development Co.; John Vogt, Pyropower, Inc.: and Robert D. Van Brocklin, PacifiCorp, joint letter ... 396
Mutual Signal Corp., William Morris, letter ... 400
National Hydropower Association, Lee M. Goodwin, letter ... 402
National Marine Engineers' Beneficial Association, C.E. DeFries, letter ... 403
National Maritime Union of America, Shannon J. Wall, letter ... 405
NorLight, James C. Rice, statement ... 407
Potlach Corp., John J. Salmon, letter and attachments ... 409
Texas Air Corp., statement ... 413
Toyota Motor Manufacturing, USA statement and attachment ... 415

Section 211:

Bowater, Inc., Alex E. Medovich, statement and attachment ... 418
Edison Electric Institute, Ronald D. Clements, statement ... 427
Federal Express Corp., John E. Chapoton, and Charles L. Almond, statement ... 428
GTE Corp., Claude A. Burleson, statement and attachments ... 429

Page
Holmes, Beverly M., Stone Mountain, Ga., letter and attachment 433
Milder, Forrest David, Brown, Rudnick, Freed & Gesmer, letter 435
New York State Electric & Gas Corp., Richard P. Fagan, statement 436

Section 212:

Georgetown Steel Corp., statement forwarded by Hon. Alex McMillan, a Representative in Congress from the State of North Carolina 438
Kaiser Aluminum & Chemical Corp., Donald V. Moorehead, statement 443
Regula, Hon. Ralph, a Representative in Congress from the State of Ohio, letter and attachment 445
Timken Co., G.W. Duggan, letter 448

Section 251:

Crockett, Hon. George W., Jr., a Representative in Congress from the State of Michigan, and Hon. Sander Levin, a Representative in Congress from the State of Michigan, joint letter 449
Mullen Advertising, Inc., James X. Mullen, statement and attachment 451

Section 252:

Associated Financial Corp., A. Bruce Rozet, statement and attachments 455
Association of Local Housing Finance Agencies, Coalition for Low and Moderate Income Housing, Council for Rural Housing and Development, Council of State Housing Agencies, Enterprise Foundation, National Association of Home Builders, National Corporation for Housing Partnerships, National Housing and Rehabilitation Association, National Housing Conference, National Leased Housing Association, National Low Income Housing Coalition, and Rural Housing Services, Inc., joint statement (also IRC Section 46) 469
Goodwin Enterprises, Richard C. Goodwin, letter, forwarded by Hon. H. James Saxton, a Representative in Congress from the State of New Jersey... 478
Jackson/Slater, Inc., Fr. Norman J. O'Connor, letter, forwarded by Hon. Frank J. Guarini, a Representative in Congress from the State of New Jersey 479
Texas Housing Agency, Charles L. Almond, Michael A. Jungman and Debra J. Duncan, statement 481
Winn Development Co., statement 483

TITLE III—CAPITAL GAINS

Section 301:

Nash, Albert, Fullerton, Calif., letter 485

Section 321:

Ince, George R., Jr., Davis, Polk & Wardwell, letter 487

TITLE IV—AGRICULTURE, ENERGY, AND NATURAL RESOURCES

Section 421:

Joint letter:
  Hon. Thomas J. Downey, a Representative in Congress from the State of New York.
  Hon. Brian J. Donnelly, a Representative in Congress from the State of Massachusetts.
  Hon. Ronnie G. Flippo, a Representative in Congress from the State of Alabama.
  Hon. Joe Kolter, a Representative in Congress from the State of Pennsylvania.
  Hon. Barbara B. Kennelly, a Representative in Congress from the State of Connecticut.
  Hon. Edward J. Markey, a Representative in Congress from the State of Massachusetts.
  Hon. Raymond J. McGrath, a Representative in Congress from the State of New York.
  Hon. Bell Frenzel, a Representative in Congress from the State of Minnesota.
  Hon. Rod Chandler, a Representative in Congress from the State of Washington.
  Hon. David O'B. Martin, a Representative in Congress from the State of New York.

Page

Hon. Jim Moody, a Representative in Congress from the State of Wisconsin.

Hon. Frank Horton, a Representative in Congress from the State of New York 489

National Independenty Energy Producers Hydroelectric Tax Reform Committee, Harrison Wellford, and Dawson Mathis, letter and attachments 491

TITLE V—TAX SHELTER LIMITATIONS; INTEREST LIMITATIONS

Section 501:

Allen, James R., San Jose, Calif., statement 499

Committee for Future Investment in America's Past, Sally G. Oldham, letter (also Section 503) 500

Friedman, Alpren & Green, Robert Kaplan, letter 503

J&B Management Co., Bernard Rodin, statement 505

Section 502:

Landmark Development, Inc., Leon E. Brock, letter and attachments 507

National Leased Housing Association, and Council for Rural Housing and Development, joint letter 511

Section 503:

California Federal Savings & Loan Association, William L. Callender, letter 512

Hale and Dorr, Steven S. Snider, letter 514

Matsui, Hon. Robert T., a Representative in Congress from the State of California, letter 516

Salmon, John J., Dewey, Ballantine, Bushby, Palmer & Wood, letter and attachment 517

Section 511:

Bank One, Dayton, NA, Probate/Tax Department, Charles T. Peterson, Jr., statement and attachment 520

Barrie, John P., Gallop, Johnson & Neuman, letter 522

Carles, Thomas S., Livingston, N.J., letter 523

Gibraltar MoneyCenter, Inc., Gregory J. Bowcott, letter 527

Rooney, David A., Rooney, Plotkin & Willey, letter 528

Seidman & Seidman, BDO, Mario P. Borini, letter 529

Thomas, Kaye A., Harter, Secrest & Emery, letter 530

Weyerhaeuser Company, Neil P. Wissing, letter and attachment 532

TITLE VI—CORPORATE PROVISIONS

Comments on more than one section:

Investment Company Institute, Catherine L. Heron, statement (Sections 631, 651, and 653) 534

Section 614:

Chadbourne & Parke, William G. Cavanagh, statement 544

Section 621:

Federal Home Loan Bank Board, and Federal Savings and Loan Insurance Corporation, Lawrence J. White, letter and attachment 547

Bloomfield, Michah, W., Stroock & Stroock & Lavan, letter 553

Hale and Door, statement 555

Hodgson, Russ, Andrews, Woods & Goodyear, statement 558

Navistar International Corp., Ronald A. Pearlman and Herbert N. Beller, joint letter 562

Section 631:

Cardin, Hon. Benjamin L., a Representative in Congress from the State of Maryland, letter 568

National Presto Industries, Inc., Joseph H. Berney, letter and attachment 569

O-W Fund, Inc., LeRoy E. Hoffberger, statement 573

Southwestern Bell Corp., William T. Brack, statement 576

Section 633:

Allen, Martin S., Goldstein & Manello, letter 579

Barrie, John P., Gallop, Johnson & Neuman, letter 581

Page
Brode, George, Jr., Chicago, Ill., statement 583
Ericksen, George W., Tampa, Fla., statement 588
IU International Corp., statement 589
Johnson, Robert L., Carlton & Johnson, letter 590
Kirsner, Marvin A., Shutts & Bowen, letter 591
Monumental Corp., Vester T. Hughes, Jr., and William B. Harman, Jr., joint statement and attachments 592
Moses, Alfred H., and Henry J. Birkkrant, Covington & Burling, statement 597
Ragan & Mason, William F. Ragan, letter 600
Ranweiler, Robert J., Biebl, Ranweiler & Co., Chartered, letter 602
SP Energy Development Co., Sanford Kinzer and Gloria Lung Wakayama, Harris, Mericle & Orr, joint letter and statement 603
Stoll, Martin A., Certilman, Haft, Lebow, Balin, Buckley & Kremer, letter 610

Section 653:

Fidelity Investments, Robert C. Pozen, Fidelity Management & Research Co., letter 612
FMR Corp., statement 616
Kau, Randall K.C., and Sharp Sorensen, Sullivan & Cromwell, joint statement 618
Putnam Management Co., Inc., Peter L. Curry, letter 622
T. Rowe Price Associates, Inc., Henry H. Hopkins, letter 623

Section 662:

Realty South Investors, Inc., A.P. Chambliss, III, letter 625

Section 671:

Humphreys, Thomas A., Brown & Wood, letter 627

Sections 671-674:

Salomon Brothers Inc., Donald B. Susswein, letter and attachments 629

TITLE VII—ALTERNATIVE MINIMUM TAX

Section 701:

Andersen, Richard E., Walter, Conston, Alexander & Green, letter 639
Cadwalder, Wickersham & Taft, Donald C. Alexander, letter 643
Compaq Computer Corp., statement 646
Coopers & Lybrand, David T. Wright, letter 648
Deming, Renee R., Fenwick, Davis & West, letter 651
F.W. Woolworth Co., Henry C. Miner, III, letter and statement 654
Kay, Thomas A., Harter, Secrest & Emery, letter 678
Levy, Joyce A., Schwartz & Freeman, letter 657
National Rural Electric Cooperative Association, Bob Bergland, letter 680
Olin Corp., statement 659
Page & Addison, Murry E. Page letter 661
Pitney Bowes Inc., Henry J. Spring, Jr., statement 663
McConaghy, Mark L., Price Waterhouse, statement 667
Stock Company Information Group, William B. Harman, Jr., statement and attachment 669

Sections 701 and 702:

Bank of America, Bankers Trust Co., Chemical Bank, Citibank, Continental Illinois National Bank & Trust Co., of Chicago, Irvin Trust Co., Manufacturers Hanover Trust Co., and Mellon Bank, John E. Chapoton, Thomas A. Stout, Jr., Christine L. Vaughn, and Debra J. Duncan (also Section 901), joint statement and attachment 682

TITLE VIII—ACCOUNTING PROVISIONS

Section 803 (industry comments):

America's Black Forum, Walker A. Williams, letter 688
American Petroleum Institute, statement 689
Association of American Publishers, Inc., Nicholas A. Veliotes, statement 690
Builders' Hardware & Supply Co., Thomas M. Shannon, letter 697
Computer Projects, Inc., Dorothy Friedberg, letter 699
South-Western Publishing Co., Edwin E. Kadrmas, letter 700
Standard Oil Co., James V. Phillips, letter 701

Section 803 (authors):

Page
Adler, Ronald B., Santa Barbara, Calif., letter and attachment 703
Anderson, Leone Castell, Stockton, Ill., letter 705
Authors Guild, Inc., statement 706
Baber, Asa, Contributing Editor, Playboy Magazine, letter 714
Biestman, Margot, Pergot Press, letter 715
Blanchard, Paula, Lexington, Mass., letter 716
Clinton, Edward, Clinton, Conn., letter 717
Clymire, Robert, Arlington, Va., letter 718
Cook, Camille J., Culinary and Fine Arts Ltd., letter 719
De Blasis, Celeste N., Victorville, Calif., letter 720
Dillon, Barry F., Arlington, VA., letter 722
Eisenstein, Phyllis, Chicago, Ill, letter 723
Felknor, Bruce L., Lake Bluff, Ill., letter 724
Haynes, James M. and Betty R., Colleyville, Tex., letter 725
Huges, Jonathan, Northwestern University, Department of Economics, Evanston, Ill., letter and attachment 726
Jorgensen, Elizabeth Watkins and Henry Irvin, Pacific Grove, Calif., letter and attachment 728
Kolaczyk, Ed and Anne, Ean Associates, Inc., letter 732
Kroger, William G., Alexandria, Va., letter 733
Kube-McDowell, Michael P., Okemos, Mich., letter 734
Lee, Barbara, Greener Pastures Press, letter 736
Mains, Karen, Chapel of the Air, letter 737
McCaughey, David C., Washington, D.C., letter 738
McLane, Helen J., Winnetka, Ill., letter 738
Meadows, Anne, Washington, D.C., letter 739
Mudd, David G. Washington, D.C., letter 740
National Writers Club and Associated Business Writers of America, James Lee Young, letter 741
Nims, Bonnie Larkin, Chicago, Ill., letter 742
Ognibene, Peter J., Silver Spring, Md., letter 743
Pottker, Janice, Potomac, Md., letter 744
Renfroe, Martha Kay, Otis, Oreg., letter and attachment 745
Severo, Richard, Newburgh, N.Y., letter and attachment 747
Stern, Geraldine, Harvard, Ill., letter 750
Stroud, Kandy, Washington, D.C., letter 751
Trahey, Jane, Trahey Advertising Inc., letter 752
Washington Independent Writers Legal and Educational Fund, Inc., Joseph Foote, letter 753
Wolpe, Hon. Howard, a Representative in Congress from the State of Michigan, forwarding letters from Althea Lindstrom, and Maris Soule 754
Wyman, Mark, Normal, Ill., letter 756
Zeilik, Michael, Santa Fe, N.M., letter 757

Section 803 (photographers):

American Society of Magazine Photographers, Helen Marcus, statement 758
Brock, Kenn, Dallas, Tex., letter 760
Crawford, Clint, Dallas, Tex., letter 761
Geffs, Dale, Houston, Tex., letter 762
Johns, Douglas, St. Petersburg, Fla., letter 763
Kiss, Bob, Kiss Photography Inc., letter 764
Leonard, Steve, Chicago, Ill., letter 765
Nance, David, Houston, Tex., letter 766
Pickerell, James H., Rockville, Md., statement 767
Smusz, Ben J., Bel-Air Photo Co., letter 773

Section 804:

Associated General Contractors of America, statement 774
Nichols, Rise & Co., Douglas L. Lacey, letter and attachment 781
Wm. R. Montgomery & Associates, Inc., Richard T. Meyer, letter 783

Section 806:

Alliance of American Insurers, Stephen W. Broadie, letter 784
Central Coast Pathology Consultants, Inc., David M. Lawrence, M.D., letter 786
National Association of Independent Insurers, Darrell Coover, letter 787

Page
Shawmut Corp., Central Tax Unit, and Massachusetts Bankers Association, Robert G. Ripley, Jr., letter 788
United Missouri Bank of Kansas City, N.A., Dorothy J. Schneider, letter 789

Section 811:

Centex Corp., statement 791
Silverman, Mark J., Steptoe & Johnson, letter and attachment 793
Spielberg, Sol, Spielberg, Herman & Aronin, letter 797
Udall, Hon. Morris K., a Representative in Congress from the State of Arizona, and Hon. Richard A. Gephardt, a Representative in Congress from the State of Missouri, joint statement 799
Wells, Robert L., Wells & Co., letter 801

Section 824:

Mogel Engineering, Inc., Emil J. Mogel, Jr., letter and attachment 802
Pacific Lighting Corp., and Southern California Gas Co., Richard A. Jackson, letter 804

TITLE IX—FINANCIAL INSTITUTION

Section 901:

Great Western Financial Corp., Michael J. Palko, letter 805

Section 902:

Cooper, Hon. Jim, a Representative in Congress from the State of Tennessee, forwarding letter from George O. Haggard, Bean Station Furniture Factory. 807
Dott, Peter B., New York, N.Y., letter and attachment 810
NOCS Group, and NOCS South Atlantic Cold Storage & Warehouse, Inc., by Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, statement and attachments 814
Pennsylvania State Public School Building Authority, Warren W. Ayres, letter and attachments 820
Waugh, Daniel C., Providence, R.I., letter 838

Section 903:

Marine Midland Bank, N.A., Gordon F. Martin, letter 840
MCorp, Richard C. Amacher, letter and statement 842

TITLE X—INSURANCE PRODUCTS AND COMPANIES

Section 1011:

Aetna Life & Casualty, Francis X. Smith, letter 846
John Hancock Mutual Life Insurance Co., Raeburn B. Hathaway, Jr., letter 847
Matsui, Hon. Robert T., a Representative in Congress from the State of California, Hon. Hal Daub, a Representative in Congress from the State of Nebraska, Hon. Ronnie G. Flippo, a Representative in Congress from the State of Alabama, Hon. Barbara B. Kennelly, a Representative in Congress from the State of Connecticut, Hon. John J. Duncan, a Representative in Congress from the State of Tennessee, Hon. Bill Frenzel, a Representative in Congress from the State of Minnesota, Hon. Frank J. Guarini, a Representative in Congress from the State of New Jersey, Hon. Harold Ford, a Representative in Congress from the State of Tennessee, Hon. Ed Jenkins, a Representative in Congress from the State of Georgia, Hon. Beryl Anthony, Jr., a Representative in Congress from the State of Arkansas, Hon. Bill Gradison, a Representative in Congress from the State of Ohio, Hon. Byron L. Dorgan, a Representative in Congress from the State of North Dakota, joint letter and attachment 849
Mutual Benefit Life Insurance Co., statement 854
Provident Life & Accident Insurance Co., John E. Chapoton, and Thomas A. Stout, Jr., statement 856

Section 1012:

American Bar Association Fund for Justice and Education, Chuck Coughlin, statement 857
American Lutheran Church, Office of the Foundation, Minneapolis, Minn., Carol A. Markuson, letter 858

Page

Boggs, Hon. Lindy (Mrs. Hale), a Representative in Congress from the State of Louisiana, forwarding letter from Charles W. Heim, Jr., Alton Ochsner Medical Foundation 859

Carnegie Mellon University, Pittsburgh, Pa., Gordon Gordon, letter 861

Children's Hospital of Philadelphia, Pa., Shirley Bonnem, letter forwarded by the Honorable William J. Coyne, a Representative in Congress from the State of Pennsylvania 862

Church of the Nazarene, Robert D. Hempel, letter 863

Coelho, Hon. Tony, a Representative in Congress from the State of California, fowarding letter from Warren Looker, Sansum Medical Research Foundation 864

Conservative Baptist National Stewardship Ministries, Harry D. Pittman, letter 866

Dartmouth College, Hanover, N.H., Frank A. Logan, letter 867

Duncan, Hon. John J., a Representative in Congress from the State of Tennessee, Hon. Guy Vander Jagt, a Representative in Congress from the State of Michigan, Hon. Bill Archer, a Representative in Congress from the State of Texas, Hon. Bill Frenzel, a Representative in Congress from the State of Minnesota, Hon. Bill Gradison, a Representative in Congress from the State of Ohio, Hon. Hal Daub, a Representative in Congress from the State of Nebraska, Hon. Rod Chandler, a Representative in Congress from the State of Washington, Hon. Raymond J. McGrath, a Representative in Congress from the State of New York, Hon. Judd Gregg, a Representative in Congress from the State of New Hampshire, joint letter 869

First Church of Christ, Scientist, Arthur D. Pinkham, Jr., letter 870

George Washington University, Washington, D.C., Jerry R. Anderson, letter 872

Harvard Medical School, Boston, Mass., John E. Abrams, letter 873

Illinois College, Jacksonville, Ill., Donald C. Mundinger, letter 874

John Brown University, Siloam Springs, Ark., John E. Brown III, letter 875

Lake Forest College, Lake Forest, Ill., Eugene Hotchkiss, letter 876

Lawrence University, Appleton, Wis., Stephen A. Hirby, letter 877

Marianist Mission, Cincinnati, Ohio, Gregory P. Olberding, letter, forwarded by the Honorable Bill Gradison, a Representative in Congress from the State of Ohio 879

Matthies, Roland C., Springfield, Ohio, letter 881

Mercersburg Academy, Mercersburg, Pa., Don D. Hill, letter 882

Mid-America Union, Conference of Seventh-Day Adventists, Lincoln, Nebr., George Woodruff, letter 883

Missionary Oblates of Mary Immaculate, Belleville, Ill., Fr. Don Ferguson, OMI, letter 884

Moravian College, Bethlehem, Pa., Roger H. Martin, letter 885

National Easter Seal Society, David G. Schmeling, letter 886

New Mexico Baptist Foundation, B. Lee Black, letter 888

Ohio Wesleyan University, Delaware, Ohio, Robert A. Holm, letter 889

Otterbein Homes, Donald E. Patterson, letter 890

Our Lady of Victory Homes of Charity, Msgr. Robert C. Wurtz, statement 892

Phillips Academy, Andover, Mass., Grace E. Curley, letter 893

Presbyterian Church in America Foundation, John W.S. Hudson, letter 894

Saint Louis Symphony Orchestra, Richard R. Hoffert, letter 895

Saint Raphael Foundation, Inc., Jane D. Crowley, letter 896

Salvation Army Territorial Headquarters, New York, N.Y., Col. Wallace C. Conrath, letter 897

Schuette, Hon. Bill, a Representative in Congress from the State of Michigan, letter 898

Seventh-day Adventists, Pacific Union Conference, John G. Tulio, letter 899

Sharp Hospitals Foundation, Phyllis A. Allen, letter 900

Society for the Propagation of the Faith, Most Rev. William J. McCormack, letter 910

United Church of Christ Homes, John R. McFadden, letter 902

United Jewish Appeal-Federation of Jewish Philanthropies of New York, Inc., Bernard Rosner, letter 903

United Methodist Foundation in Western North Carolina, Richard D. Bailey, statement 904

United Methodist Homes for the Aging of the Wyoming Conference, David Fanning, letter 906

United Methodist Homes of New Jersey, Charles R. Murray, letter 908

University of Maryland, Clearinghouse for Research on Fund Raising, College Park, Md., Robert F. Carbone, letter 909

Page

University of Minnesota, College of Education, Minneapolis, Minn., David J. Madson, letter 910
University of Texas at El Paso, James M. Peak, letter 911
University of Tulsa, Okla., Edwin C. Eanes, letter 912
University of Vermont, Burlington, Vt., Robert W. Gibson, letter 913
William Penn Charter School, Philadelphia, Pa., William D. Ravdin, letter 914
Section 1012—Similar letters were also received from the following (not printed but retained in Committee files);
  Air Force Village Foundation, San Antonio, Tex., Omar Pitman, letter.
  Albertus Magnus College, New Haven, Conn., Julia M. McNamara, O.P., letter.
  Albright College, Reading, Pa., Patricia N. Moulton, letter.
  All Saints' Episcopal Church, Beverly Hills, Calif., M. Gregory Richards, Rector, statement.
  America's Keswick, Whiting, N.J., William E. Bibik, letter.
  American Baptist Churches, Ministers and Missionaries Benefit Board, New York, N.Y., Dear R. Wright, letter.
  American Baptist Foreign Mission Society, Valley Forge, Pa., William E. Jarvis, letter.
  American Diabetes Association, Oklahoma Affiliate, Inc., Tulsa, Okla., Ann Richards Ketcham, letter.
  American Heart Association, Iowa Affiliate, Mrs. Vicki Kimes, letter.
  American Leprosy Missions, Elmwood Park, N.J., Eugene L. Wilson, letter.
  AMG International, Chattanooga, Tenn., Otto A. Anderson, letter.
  Andrews University, Berrien Springs, Mich., Oliver L. Johnston, letter.
  Anne Carlsen School, Jamestown, N.D., Henry Edwards, letter.
  Arkansas Baptist Foundation, Little Rock, Ark., Harry D. Trulove, letter and attachment.
  Art Center College of Design, Pasadena, Calif., Warren B. Knox, letter.
  Auburn Alumni Association, Auburn University, Ala., Jerry F. Smith, letter.
  Augustana College, Rock Island, Ill., James D. Horstmann, letter.
  Austin College, Sherman Tex.:
    William R. McLeRoy, letter.
    J. Thomas Stewart, letter.
  B'nai B'Rith Foundation of the U.S., Sidney H. Closter, letter.
  Baldwin-Wallace College, Berea, Ohio, Thomas H. Konkoly, letter.
  Bangor, Maine, Theological Seminary, Susan L. Grove-Markwood, letter.
  Baptist Bible College & Theological Seminary, Clarks Summit, Pa., Milo Thompson, Jr., letter.
  Baptist Foundation of Oklahoma, Oklahoma City, Okla., Robert L. Ross, W.G. Kersh, and C. Duane Riley, joint letter.
  Baptist Health Services Foundation, Gadsden, Ala., George P. Gray, Jr., letter.
  Baptist Hospital Fund, Midway and Mounds Park Hospitals, St. Paul, Minn., James B. Field, letter.
  Barlow, Argus S., Brevard, N.C., letter.
  Bates College, Lewiston, Maine, Eugene G. Taylor, letter.
  Baylor University Medical Center Foundation, Dallas, Tex., Dan T. Garrett, letter.
  Bellevue College Foundation, Bellevue, Neb., Patricia J. Morocco, letter.
  Berea College, Berea, Ky., Lou S. Lakes, letter.
  Betheny College, Lindsborg, Kansas, R. Jay Ribble, and Donald E. Trued, letters.
  Bethphage Mission, Inc., Omaha, Neb., David A. Jacox, letter.
  Bible Literature International, Columbus, Ohio, James R. Falkenberg, President.
  Biola University, La Mirada, Calif., Gary R. Boren, letter.
  Blair Academy, Blairstorn, N.J., Mary C. Tychonievich, letter.
  Bongard, Diane, Cincinnati, Ohio, letter.
  Bowling Green State University, Bowling Green, Ohio, Dwight F. Burlington, and John H. Fogel, letters.
  Boys Club of Fort Worth, Tex., Tracey Brown, letter.
  Bradley University, Peoria, Ill., Ian T. Sturrock, letter.
  Brebeuf Preparatory School, Indianapolis, Inc., M. Joseph Casey, S.J., letter.

Bremwood Lutheran Children's Home Society, Waverly, Iowa, Harold Hunter, letter.
Brevard College, Brevard, N.C., Mark A. Bailey, letter.
Brockport College of the State University of New York, Patric S. Madama, letter.
Bryan College, Dayton, Tenn., Kenneth G. Hanna, letter.
Buckner Baptist Benevolences, San Antonio, Tex., Micheal Nealeigh, letter.
Buena Vista College, Storm Lake, Iowa, J. Robert Siefer, letter.
Bush School, Seattle Wash., John R. Corkran, letter.
Calhoun School, New York, N.Y., Marilyn Stuart, letter.
California Lutheran University, Thousand Oaks, Calif., Jerry H. Miller, letter.
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter.
California State University, Dominguez Hills, Carson, Calif., Kenneth W. Finlay, letter.
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter.
Callahan, Timothy A.R., Birmingham, Ala., letter.
Calumet College, Whiting, Ind., Father Ronald J. Schiml, C.PP.S., letter.
Calvin College and Seminary, Grand Rapids, Mich., John Heerspink, letter.
Campbellsville, Ky., College, Kenneth H. Pope, letter.
Canton, Ohio, Christian Home, Larry Burgett, letter.
Capper Foundation, Topeka, Kansas, Edward F. Gibbons, and Monty E. Nelson, joint letter.
Carle Foundation, Urbana, Ill., W. Frank Elston, letter.
Carlisle Group, Carlisle, Pa., George W. Bahner, letter.
Case Western Reserve University, Frances Payne Bolton School of Nursing, Cleveland, Ohio, Sandra Deller, letter.
Catholic Archdiocese of Seattle, Wash., Steve Kocharhook, letter.
Catholic Chancery, Diocese of Kansas City-St. Joseph, Mo., Denis Putthoff, letter.
Catholic Charities of the Archdiocese of Dubuque, Iowa, James L. Yeast, letter.
Catholic Foundation, Dallas, Tex., Hal F. Tehan, letter.
Catholic Missions Office, Diocese of Joliet, Ill., Rev. John P. Driscoll, letter.
Cedarville, College, Cedarville, Ohio, Martin E. Clark, and Robert K. Rohm, letters.
Center for Creative Studies, Detroit, Mich., Dennis E. Moore, letter.
Chaddock, Quincy, Ill., Marge Ozley.
Cheyenne Mountain Zoological Park, Colorado Springs, Colo., Karen Murray, letter.
Chicago School of Professional Psychology, Kathleen Slomski, letter.
Chicago Lung Association, John L. Kirkwood, letter.
Chicago School of Professional Psychology, Kathleen Slomski, letter.
Child Evangelism Fellowship Inc., Warrenton, Mo., Paul E. Blackburn, statement.
Children's Hospital, Phoenix, Ariz., Barbara L. Grier, letter.
Children's Hospital Foundation, Denver, Colo., Herman J. West, letter.
Children's Hospital National Medical Center, Washington, D.C., Terry L. Lierman, and Thomas D. Walsh, joint letter.
Children's Mercy Hospital, Kansas City, Mo., Lawrence A. McAndrews, letter.
Christian Appalachian Project, Lancaster, Ky., William A. Begley, letter.
Christian Church in the Upper Midwest, Des Moines, Iowa, James S. Kratz, letter.
Christian Record Braille Foundation, Inc., Lincoln, Neb., Vernon L. Bretsch, letter.
Christian Reformed Home Missions, Grand Rapids, Mich., R. Jack De Vos, letter.
Church of Jesus Christ of Latter-Day Saints, Ron S. Taylor, letter.
Cincinnati, Ohio, Country Day School, William H. Hopple, III, letter.
City of Hope, Cincinnati, Ohio, Herbert E. Ostrov, Ruth J. Preston, Mary Bridget Reilly, and Diane Bongard, letters.
Claremont School of Theology, Claremont, Calif., David H. Nienas, letter.

Clark University, Worcester, Mass., Rilchard P. Traina, letter.
Clarke College, Dubuque, Iowa, Catherin Dunn, and Therese Mackin, letters.
College of Du Page, Glen Ellyn, Ill., D. Richard Petrizzo, letter.
College of Idaho, Caldwell, Idaho, W. Michael Born, letter.
College of Mount S. Joseph on the Ohio, Cincinnati, Ohio, Mary Declan Browne, letter.
College of New Rochelle, N.Y., Sister Dorothy Ann Kelly, O.S.U., letter.
College of Saint Rose, Albany, N.Y., John C. Barner, letter.
College of St. Francis, Jolliet, Ill., Stephen F. Stauffenberg, letter.
College of Wooster, Ohio, Grace M. Tompos, letter.
Colgate University, Campaign for Colgate, Hamilton, N.Y., Donald F. Martin, letter.
Columbia College, Columbia, South Carolina, Robert T. Barham, letter.
Columbia College, Columbia, Mo., Ralph E. Glenn, letter.
Columbian Fathers, St. Columbans, Nebr., Rev. John M. Lagomarsino, letter and attachment.
Community Counselling Service Co., Inc., Western Division, San Francisco, Calif., Michael A. DeNunzio, letter.
Concordia College, Moorhead, Minn., David M. Benson, letter.
Concordia College, Ann Arbor, Mich., Thomas A. Fitchett, letter.
Concordia College, Bronxville, N.Y., Hans G. Springer, letter.
Concordia College of St. Paul, Minn., Michael D. Flynn, letter.
Conservative Baptist Foundation of Arizona, Phoenix, Ariz., Paul G. Spears, letter.
Corcoran School of Art, Washington, D.C., Sally J. Smith, letter.
Cornell College, Mount Vernon, Iowa, David Marker, letter.
Corpus Christi, Texas, Diocese of, Rev. Randy Majek, letter.
Council on Health & Human Services, Wisconsin Conference/United Church of Christ, Dennis Streiff, letter.
Culver Educational Foundation, Culver, Ind., Channing E. Mitzell, letter.
Cumberland Presbyterian Church Board of Finance, Foundation and Management, Memphis, Tenn., Don Alexander, letter.
Dakota Wesleyan Univesity, Mitchell, S.D., Stan Haidle, letter.
De Moines, Iowa, Diocese of, Nancy Perazelli, letter.
Deaconess Foundation, Cleveland, Ohio, Susan Ell, letter.
Denison University, Granville, Ohio., J. Leslie Hicks, Jr., letter.
Denver Conservative Baptist Seminary, Denver, Colorado, Donald D. Orivs, letter.
Dickinson College, Carlisle, Pa., A. Lee Fritschler, letter.
Dominick, Frank, Dominick, Fletcher, Yeilding, Wood & Lloyd, Birmingham, Ala., letter.
Donald A. Campbell & Company, Inc., Chicago, Ill., Thomas G. Sanberg, letter.
Drew University, Madison, N.J., Steven Kavanaugh, letter.
Drexel Hill, Pa., School of the Holy Child, Sr. Barbara Foy, SHCJ, letter.
Drexel University, Philadelphia, Pa., Carolyn A. Sprogell, letter.
Drury College, Springfield, Mass., Kathy S. Evans, letter.
Dubuque, Iowa, Archdiocese of, Fr. John J. O'Connor, letter.
Eagle Village, Inc., Hersey, Mich., Willard P. Hedberg, letter.
East Carolina University, Greenville, N.C., Micah D. Ball, letter.
Eastern College, Eastern Baptist Theological Seminary, St. Davids, Pa., William R. Rueckle, letter.
Eastern Mennonite High School, Harrisonburg, Va., Les Helmuth, letter.
Elyria, Ohio, United Methodist Home, Charles V. Watt, letter.
Episcopal Church Center, New York, N.Y., Frederick Osborn III, letter.
Episcopal High School, Alexandria, Va., Nathaniel H. Acker, letter.
Erie Diocesan Mission Office, Father Daniel J. Kresinski, letter.
Eureka College, Eureka, Ill., George A. Hearne, letter.
Evangelical Covenant Church, Chicago, Ill., LeRoy M. Johnson, letter.
Evangelical Free Church of America, Minneapolis, Minn., Gene Jones, letter.
Evangelistic Faith Missions, Bedford, Ind., Rev. J.B. "Juddie" Peyton, letter.
Fairfield, Conn., University, James E. Reilly, letter.
Family Service Detroit and Wayne County, Mich., Mary Jane Michaels, letter.
Fay School, Southborough, Mass., Martin Haley, letter.

FCNL Education Fund, Washington, D.C., Edward F. Snyder, letter.
Fellowship of Reconciliation, Nyack, N.Y., John Horn, letter.
Florida Institute of Technology, Melbourne, Fla., Keener Smathers, letter.
Florida Presbyterian Homes, Inc., Lakeland, Fla., Daniel D. Dickenson, letter.
Florida State University Foundation, Tallahassee, Fla., Paula S. Fortunas, letter.
Florida United Methodist Children's Home, Enterprise, Fla., Charles H. Goodrich, letter.
Fort Sanders, Foundation, Knoxville, Tenn., Paul G. Alexander, letter.
Four County Mental Health Services, Inc., St. Charles, Mo., Karl Wilson, and Jill Ditchik, joint letter.
Fox Chase Cancer Center, Philadelphia, Pa., Sandra W. Weckesser, letter.
Frantzreb, Arthur C., Arthur C. Frantzreb, Inc., McLean, Va., letter.
Freed-Hardeman College, Henderson, Tenn., E. Claude Gardner, letter.
Freedom from Hunger Foundation, Davis, Calif., John Logan, letter.
Friends of Israel Gospel Ministry, Inc., Bellmawr, N.J., William E. Sutter, Fred Hartman, Marvin J. Rosenthal, and William C. Varner, joint letter.
Friends of Mercy, Springfield, Ohio, John E. Pickarski, letter.
Geisinger Foundation, Danville, Pa., H.W. Wieder, Jr., letter.
General Conference Auditing Service, Washington, D.C., O. Richard Caldwell, letter.
Georgia Baptist Foundation, Inc., Atlanta, Ga., Donald L. Folsom, letter.
Georgian Court College, Lakewood, N.J., Sister Barbara Williams, letter.
Georgetown College, Georgetown, Ky., R. Richard Carlton, letter.
Girl Scouts, Plymouth Bay Girl Scout Council, Inc., Taunton, Mass., Robert A. Lewis, letter.
Gonzaga University, Spokane, Wash., Jane Orr, letter.
Good Samaritan Society, Sioux Falls, S.D., Raymond L. Mehl, and Randy Fitzgerald, joint letter.
Goodman, Woodrow, Upland, Calif., letter.
Goodwill Industries of Pittsburgh, Goodwill Industries of Fayette County, Uniontown, Pa., and Goodwill Plaza, Inc., Pittsburgh, Pa., Donna M. DeBlasis, letter.
Gordon Technical High School, Chicago, Ill., Robert R. Morris, letter.
Gordon-Conwell Theological Seminary, South Hamilton, Mass., Donald L. Stahl, letter.
Grace Brethren Financial Planning Service, Winona Lake, Ind., Russel H. Dunlap, letter.
Grace Day Home, Sacramento, Calif., Sister Jeanne Rollins, OSF, letter.
Grand Rapids, Mich., Baptist College & Seminary, Norman O. House, letter.
Grant Hospital Development Foundation, Columbus, Ohio, statement.
Green Mountain College, Poultney, Vt., Christian Allan King, letter.
Groton School, Groton, Mass., Glenn W. Boynton, letter.
Harbor Day School, Corona del Mar, Calif., Lucinda M. Marder, letter.
Hardin-Simmons University, Abilene, Tex., Carlyle B. Hayes, letter.
Harding University, Searcy, Ark., C. Alvin Fowler, letter.
Hargrave Military Academy, Chatham, Va., William C. Amidon, letter.
Harker Academy, San Jose, Calif., Susan C. Covey, letter.
Hartwick College, Oneonta, N.Y., Meryl E. Best, letter.
Harvard University, Graduate School of Business Administration, Ellen W. Ryan, letter.
Haven of Rest Ministries, Los Angeles, Calif., J.P. Atkinson, letter.
Haverford School, Haverford, Pa., Murray Dodge, letter.
Hilton Head, S.C., Preparatory School, Caroline G. McGee, letter.
Hogue, Louise N., Bronxville, N.Y., letter.
Holy Cross Hospital Foundation, Fort Lauderdale, Fla., Lana C. Wingerson, letter.
Holy Family College, Philadelphia, Pa., Margaret Swoboda Kelly, letter.
Hospital Association of Metropolitan St. Louis, Mo., Stephen E. Dorn, letter.
Houghton College, Houghton, and West Seneca, N.Y., Ralph C. Young, letter.
Illinois Baptist State Association, Springfield, Ill., Craig A. Ridings, letter.
Incarnate Word College, San Antonio, Tex., Thomas K. Flofchan, letter.

Indiana University Foundation, Bloomington, Ind., Timothy L. Seiler, letter.
Indiana University of Pennsylvania, The Foundation, Anthony F. Lenzi, letter.
Indianapolis, Ind., Art League, Joyce A. Sommers, letter.
Intermed-USA, Inc., Dooley Foundation, New York, N.Y., Verne Chaney, M.D., letter.
Intermountain Deaconess Home for Children, Helena, Montana, Gwen Williams, letter.
International Children's Care, Inc., Terry D. Gobel, letter.
International Voluntary Services, Inc., Donna G. Lucas, letter.
InterVarsity Christian Fellowship, Madison, Wis., John Swenson, letter.
James Madison University, Harrisonburg, Va., Don R. Moore, II, letter.
Jamestown College, Jamestown, N.D., James S. Walker, letter.
Jewish Community Foundation, Boca Raton, Fla., Arthur H. Jaffe, letter.
Jewish Federation of St. Louis, Mo., William Kahn, letter.
Johnson, William K., Bloomington, Ill., letter.
Jones, Westley J.A., Stockton, Calif., letter.
Junior Achievement of the Chisholm Trail, Inc., Fort Worth, Tex., Carolum Martchenke, letter.
Kaniecki, Michael J., S.J., Bishop of Fairbanks, Alaska, letter.
Kassouf, L. Paul, CPA, L. Paul Kassouf & Co., Birmingham, Ala., letter.
Kentucky Baptist Foundation, Middletown, Ky., Barry G. Allen, letter.
Kentucky Baptist Homes for Children, Middletown, Ky., Tom Moore, letter.
Kimberton Waldorf School, Kimberton, Pa., Terry Neville, letter.
King's College, Wilkes-Barre, Pa., Rev. Laurence M. Olszewski, letter.
Kirksville College of Osteopathic Medicine, Kirksville, Mo., Phillip E. Messner, letter.
Kiski School, Slatsburg, Pa., Malcolm S. Hayden, letter.
Kiwanis Camp Wyman, Eureka, Mo., E. Battle Smith, letter.
Lake Forest College, Lake Forest, Ill., William R. Lowery, letter.
Lamar University System, Beaumont, Tex., W.S. "Bud" Leonard, letter.
Lancaster Country Day School, Lancaster, Pa., letter.
Lancaster, Pa., Community Hospital of, Elizabeth A. Kauffman, letter.
Landrebe, Robert S., Carol Stream, Ill., letter and attachment.
Lasell Junior College, Newton, Mass., John McDonagh, letter.
Lee Holthaus & Associates, Wheaton, Ill., Lee Halthaus, letter.
Lenni-Lenape Girl Scout Council, Inc., Butler, N.J., Marjorie G. Price, letter.
Lenoir-Rhyne College, Hickory, N.C., Clarence L. Pugh, letter.
Lewis & Clark College and Law School, Portland, Ore., Eugene R. Gregory, letter.
Lexington Theological Seminary, Lexington, Ky., James M. Wray, Jr., letter.
Lincoln Memorial University, Harrogate, Tenn., Gary J. Burchett, letter.
Loma Linda University, Loma Linda, Calif., George Carambot, letter.
Long Island College Hospital, Brooklyn, N.Y., Barbara J. Kohuth, letter.
Longwood College, Farmville, Va., Donald Lee Lemish, letter.
Louisville Presbyterian Theological Seminary, Louisville, Ky., Anne S. Caldwell, letter.
Loyola University, New Orleans, La., Charles E. Young, letter.
Lubbock Christian College, Lubbock, Tex., Steven S. Lemley, letter.
Lutheran Church in America Foundation, New York, N.Y., Kenneth C. Feinour, Jr., letter.
Luzerne County Community College Foundation, Nanticoke, Pa., Westley E. Franklin, letter.
Maitland Art Center, Maitland, Fla., Ethel Eber Scures, letter.
Malvern Preparatory School, Malvern, Pa., John P. Wilwol, letter.
Manhattan Christian College, Manhattan, Kansas, Wendell Sack, letter.
March of Dimes Birth Defects Foundation, Central California Chapter, Fresno, Calif., Lynne R. Senn, letter.
Marist College, Poughkeepsie, N.Y., Anthony J. Cernera, letter.
Mary Baldwin College, Staunton, Va., Garth A. Mills, Sr., letter.
Marylhurst College, Marylhurst, Ore., Nancy Wilgenbusch, letter.
Maryville College, St. Louis, Mo., Mary Konrad Feller, letter.

Massachusetts Society for the Prevention of Cruelty to Children, Boston, Mass., Elizabeth D. Giles, Loretta A. Kowal, Josephus Long, and Arthur Makar, letter.
Massanutten Military Academy, Woodstock, Va., James G. Davis, Jr., letter.
McGladrey Hendrickson & Pullen, Elkhart, Ind., John M. Wolf, letter.
McLean School of Maryland, Potomac, Md., Judith C. Elliott, letter.
Medcenter One Foundation, Bismarck, N.D., Yvonne Kroll, and Alice Rouse, letters.
Medical College of Georgia, Augusta, Georgia, Bruce L. Howerton, letter.
Medical College of Pennsylvania, Philadelphia, Pa., James E. Connell, letter.
Memorial Foundation of Allen Hospital, Waterloo, Iowa, Walter R. Cochran, letter.
Mennonite Brethren Churches Board of Trustees, Hillsboro, Kansas, Marvin L. Reimer, letter.
Middlebury College, the Campaign for, Middlebury, Vt., David E. Thompson, letter.
Millikin University, Decatur, Ill., Wayne W. Krows, letter.
Mills College, Oakland, Calif., Mary S. Metz, letter.
Minneapolis Children's Foundation, Minneapolis, Minn., Nancy Larson Haskin, letter.
Montreat-Anderson College, Montreat, N.C., W.M. Sessler, letter.
Moorestown Friends School, Moorestown, N.J., Sandy Want, letter.
Morrisville College Foundation, Inc., Morrisville, N.Y., Jon D. Denison, letter.
Mount Mercy College, Cedar Rapids, Iowa, John E. Malone, letter.
Mount Sinai Medical Center, New York, N.Y., Blair Hearth, letter.
Mt. Angel Abbey, St. Benedict, Ore., Br. Sebastian White, OSB, letter.
Natioanl Catholic Educational Association, Washington, D.C., Catherine T. McNamee, letter.
National College of Chiropractic, Lombard, Ill., James F. Winterstein, letter.
National Jewish Center for Immunology and Respiratory Medicine, Denver, Colo., J.W. Reardon, letter.
National Rehabilitation Hospital, Washington, D.C., Edward A. Eckenhoff, letter.
Navigators, Colorado Springs, Colo., Russell P. Reid, letter.
New England Baptist Hospital, Boston, Mass., Thomas J. Bachmeyer, letter.
New Jersey Institute of Technology, Newark, N.J., Sue Sugahara, letter.
New Mexico Boys Ranch and Girls Ranch, Boys Ranch, N.M., Charles E. Gibson, letter.
North Central College, Naperville, Ill., H. Kenwood Lewis, letter.
North Pacific Union Conference Association of Seventh-day Adventists, Portland, Ore., Leonard A. Ayers, letter.
North Yarmouth Academy, Yarmouth, Maine, Bruce T. Myers, letter.
Northeast Louisiana University, Monroe, La., William E. Laird, letter.
Northeastern University, The Century Fund, Boston, Mass., James H. Stoessel, statement.
Northern Arizona University, Flagstaff, Ariz., Robert E. Crozier, letter.
Oak Grove Lutheran High School, Fargo, N.D., Howard Correll, letter.
Oblate Missions, Missionary Association of Mary Immaculate, San Antonio, Tex., Fr. Edward J. Cronin, letter.
Occidental College, Los Angeles, Calif., Richard T. Cooper, letter.
Oglethorpe University, Atlanta, Ga., Harold C. Doster, letter.
Ohio Northern University, Ada, Ohio, Gregory C. Bobonich, letter.
Ohio Presbyterian Retirement Services Foundation, Columbus, Ohio, Harold P. Hamilton, letter.
Oklahoma Christian College, Oklahoma City, Okla., Alan W. Phillips, letter.
Oklahoma United Methodist Foundation, Inc., Oklahoma City, Okla., Elwyn O. Thurston, letter.
Open Bible Standrd Churches, Department of Christian Stewardship, Eugene, Ore., Robert J. Haynes, letter.
Oregon Episcopal School, Portland, Ore., Barbara Bell, letter.
Ott, Daniel D., Gainesville, Fla., letter.
Ouachita Baptist University, Arkadelphia, Ark., John Cloud, letter.

Ozanam Home for Boys, Kansas City, Mo., Paul Gemeinhardt, letter.
Pacific Lutheran University, Tacoma, Wash., William O. Rieke, letter.
Pacific Union College, Angwin, Calif., Wib Dale, Alumni Association, and Herbert Ford, letters.
Palm Beach, Fla., Diocese of, Hal Johnson, letter.
Palmer College of Chiropractic, Davenport, Iowa, D.P. Kern, William F. Holmberg, Alumni Association, and Charles K. Peart, Department of Development, letters.
Palmer College of Chiropractic, Department of Development, Davenport, Iowa, Charles K. Peart, letter.
Paoli Memorial Hospital, Paoli, Pa., A. Sidney Williams, letter.
Peace College, Raleigh, N.C., S. David Frazier, letter.
Piedmont Technical College Foundation, Greenwood, S.C., Ernest W. Prewett, Jr., letter.
Pine Manor College, Chestnut Hill, Mass., Leslie E. Ford, letter.
Pine Point School, Stonington, Conn., Mary Ellen Sherwood, letter.
Pittsburg State University, Pittsburg, Kansas, Donald C. Widner, letter.
Pittsburgh, Diocese of, Pittsburgh, Pa., Francis Devlin, letter.
Planned Giving Specialist, Inc., Brooklyn, N.Y., Leonard G. Clough, letter.
Plattsburgh College Foundtion, Plattsburgh, N.Y., Donald L. Garrant, letter.
Polytechnic University, Brooklyn, N.Y., Jane Bickford, letter.
Pomfret School, Pomfret, Conn., Anthony B. McClellan, letter.
Presbyterian Children's Services, Farmington, Mo., James W. Thurman, and Dorothy L. Williams, letters.
Presbyterian Healthcare Foundation, Albuquerque, N.M., Mary D. Poole, letter.
Presbyterian Home of South Carolina, Summerville, S.C., Ronald C. Crossley, letter.
Queen of the Valley Foundation, West Covina, Calif., John M. Tincher, letter.
Ramsey Home Retirement Center, Des Moines, Iowa, Linda L. Kirkman, letter.
Randolph-Macon Woman's College, Lynchburg, Va., James C. Kughn, Jr., letter.
Rappahannock Community College Educational Foundation, Inc., Warsaw, Va., Patricia A. Nicholas, letter.
RBMU International, Philadelphia, Pa., Dale Leathead, letter.
Redwood Terrace, Escondido, Calif., Richard L. Henrickson, letter.
Rice University, Houston, Tex., Kent E. Dove, letter.
Richmond Technical College Foundation, Inc., Hamlet, N.C., Edward B. Dodd, letter.
Rochester Institute of Technology, Rochester, N.Y., C.J. Young, letter.
Rochester, University of, Rochester, N.Y., D.K. Hess, letter.
Rogala, Lea Ann, Elmhurst, Ill., letter.
Roger, David L., New Berlin, Wis., letter.
Rollins College, Winter Park, Fla., Elizabeth Brothers, letter.
Rumsey Hall School, Washington, Conn., Thomas W. Farmen, Headmaster, letter.
Ryckman's Emergency Action & Consulting Team, St. Louis, Mo., D.W. (Rick) Ryckman, letter.
Sacred Heart League, Walls, Miss., Roger Courts, letter.
Saddle River Day School, Saddle River, N.J., Marilyn J. Jaehnel, letter.
Saginaw Valley State College Foundation, University Center, Mich., Albert J. Beutler, letter.
Saint Augustine's College, Raleigh, N.C., James R. Mitchell, Jr., letter.
Saint John's University, Collegeville, Minn., John Crosby, letter.
Saint Joseph Medical Center Foundation, Burbank, Calif., Frank J. Mayo, letter.
Saint Joseph's University, Philadelphia, Pa., Warren W. Klenk, letter.
Saint Meinrad Archabbey, St. Meinrad, Ind., Rt. Rev. Timothy Sweeney, O.S.B., letter.
Salestian Missions, New Rochelle, N.Y., Father Edward, S.D.B., letter.
Salisbury State College, Salisbury, Md., Gary Less Pielemeier, letter.
Salvation Army:
  Alabama-Louisiana-Mississippi Divisional Headquarters, Jackson, Miss., Abb L. Hatten, letter.

  - Eastern Pennsylvania and Delaware Division, Philadelphia, Pa., Lt. Col. Paul A. Rader, letter.
  - Hawaiian Islands Divisional Headquarters, Robert J. Stillwell, letter.
  - Illinois, Canton Citadel Corps, Captain Kjell Steinsland, letter.
  - Illinois, Decatur, Captain John L. Mallett, letter.
  - Illinois, Galesburg Corps Community Center, Captain Larry Manzella, letter.
  - Illinois, Bourbonnais, Kandakee Advisory Board, Lester J. Soucie, letter.
  - Illinois, West Frankfort Citadel Corps Community Center, Major Jerry E. Sword, letter.
  - Indiana Divisional Headquarters, Indianapolis, Ind., Lt. Col. William F. Himes, letter.
  - National Capital and Virginia Division, Washington, D.C., William P. De Moranville, letter.
  - Midland Division, St. Louis, Mo., Lt. Col. M. Lee Hickam, letter.
  - New York, Empire State Division, Syracuse, N.Y., Lt. Col. Edward Fritz, letter.
  - New York, Greater New York Divisional Headquarters, New York, N.Y., Lt. Col. Paul M. Kelly, letter.
  - Ohio, Cleveland, H. Robert Wismar, Jr., letter.
  - Southwest Ohio-Northeast Kentucky Division, Cincinnati, Ohio, Peter M. Kemper, letter.
  - U.S.A. Western Territorial Headquarters, Rancho Palos Verdes, Calif., Derrell D. Brown, letter.
- Samford University, Birmingham, Ala., Michael Duduit, and James N. Lewis, Jr., letters.
- San Jose, Calif., Symphony Orchestra, Judity Blase, letter.
- Sansum Medical Research Foundation, Santa Barbara, Calif., Warren Looker, and Kenneth R. Edwardsen, letters.
- Schmehl, Peter W., DeSantis, Schmehl & DeSantis, Reading, Pa., letter.
- School Sisters of Saint Francis, United States Province, Milwaukee, Wisconsin, Sister Patricia Bates, et al., joint letter.
- Science of Mind Foundation, Los Angeles, Calif., William M. Lynn, letter.
- Sears Memorial Methodist Center, Abilene, Tex., Iris Nash, letter.
- Seattle Pacific Foundation, Seattle Pacific University, Seattle, Wash., G. Roger Schoenhals, letter.
- Seventh-day Adventists:
  - Atlantic Union Conference, South Lancaster, Mass., Dale R. Beaulieu, letter.
  - Columbia Union Conference Association, Harvey L. Sauder, letter.
  - General Conference, Washington, D.C., Wyman S. Wager, letter.
  - Idaho Conference, Boise, Idaho, Southern Idaho Corp., Leon Cornforth, letter
  - Iowa-Missouri Conference, West Des Moines, Iowa, Harvey J. Byran, letter.
  - Kansas-Nebraska Conference, Topeka, Kansas, Joel Thompkins, letter.
  - Michigan Conference Association, Lansing, Mich., Ralph Trecartin, letter.
  - New York Conference Association, Syracuse, N.Y., W. Robert Daum, letter.
  - Northern New England Conference, Portland, Maine, Terry McCormick, letter.
  - North Pacific Union Conference Association, Portland, Oregon, Leonard L. Ayers, letter.
  - Pennsylvania Conference, Reading, Pa., Jake Knight, letter.
  - Southwestern Union Conference, Southwest Estate Services, Inc., Charles F. O'Dell, letter.
  - Texas Conference Association, Alvarado, Tex., C.M. May, letter.
  - Western Washington Corporation, Bothell, Washington, I.E. Burke, letter.
- Sharp Hospitals Foundation, San Diego, Calif., Phyllis A. Allen, letter.
- Shattuck-St. Mary's School, Faribault, Minn., John Lauerman, letter.
- Siegener, Sharon, Sedan, Kansas, letter.
- Sioux Falls College, Sioux Falls, S.D., Leon Bill, letter.
- Smith College, Northampton, Mass., Jane Stuber, letter and attachments.

Society for the Propagation of the Faith:
  Baltimore, Md., Myrtle B. Stanley, Archdiocesan Director, letter.
  Brooklyn, N.Y., Rev. Msgr. John J. Condon, Diocesan Director, letter.
  Cleveland, Ohio, Rev. Ralph E. Wiatrowski, Diocesan Director pro tem, letter.
  Merrillville, Ind., Rev. J. Patrick Gaza, Diocesan Director, letter.
  Oakland, Calif., Rev. Gary B. Tollner, Diocesan Director, letter.
  Rockville Centre, N.Y., Msgr. Lawrence F. Ballweg, Diocesan Director, letter.
  Saginaw, Mich., Diocese of, Rick Nix, Mission Office, letter.
  San Antonio, Tex., Sr. Evangeline Escobar, F.M.I., Archdiocesan Director, letter.
  Seattle, Wash., Barbara Geraci, Archdiocesan Director, letter.
Society of Automotive Engineers, Inc., Warrendale, Pa., James W. Cunningham, letter.
Somerset Medical Center, Somerville, N.J., John L. Galloway, letter.
South Dakota State University Foundation, Brookings, S.D., Jeffrey B. Nelson, letter.
South Iowa Methodist Homes, Des Moines, Iowa, John F. Courter, letter.
Southern Baptist College, Walnut Ridge, Ark., William P. Oakley, letter.
Southern California & Hawaii Foundation, Los Angeles, Calif., Roy I. Madsen, letter.
Southwestern Baptist Theological Seminary, Fort Worth, Tex., James Holcomb, letter.
Southwestern College, Winfield, Kansas, Lewis E. Gilbreath, letter.
Southwestern Medical Foundation, Dallas, Tex., Charles C. Sprague, M.D., letter.
Southwestern University at Georgetown, Texas, Richard B. Eason, letter.
Spectrum Planning Group, Ltd., Rochester, N.Y., Alan R. Ziegler, letter.
St. Andrews Presbyterian College, Laurinburg, N.C., Jack W. Powers, letter.
St. Augustine College, Chicago, Ill., Joaquin Villegas, letter.
St. Bonaventure Indian Missions and School, Eastern Navajo Reservation, Thoreau, N.M., Rev. Douglas A. McNeill, letter.
St. Cloud State University, St. Cloud, Minn., I Thomas Macgillivray, letter.
St. Edward's University, Austin, Tex., Robert S. Fritsch, letter.
St. Francis Homes, Inc., Salina, Kansas, The Rev. Canon Kenneth Yates, letter.
St. John's Medical Center Foundation, Longview, Wash., Max R. Mehlhaff, letter.
St. Margaret's School, Tappahannock, Va., Margaret G. Taylor, letter.
St. Ursula, Cincinnati, Ohio, Sister Mary Jerome Buchert, letter and attachment.
St. Xavier High School, Cincinnati, Ohio, Richard P. Klus, letter.
Stanley Clark School, South Bend, Ind., Donald R. Rawson, letter.
Starr Commonwealth Schools, Albion, Mich., Arlin E. Ness, letter.
State University College at Oswego Foundation, Inc., Oswego, N.Y., John D. Kleven, letter.
Stony Brook Foundation, State University of New York at Stony Brook, Long Island, N.Y., Santos T. Abrilz, Jr., letter.
Stout University Foundation, Inc., Menomonie, Wis., David K. Williams, letter.
Sun Health Foundation, Sun City, Ariz., Leonard L. Gibb, letter.
Support Center of Memphis, Tenn., Fannie Belle Burnett, letter.
Susquehanna University, Selinsgrove, Pa., Sara G. Kirkland, letter.
Sweet Briar College, Sweet Briar, Va., Martha Mansfield Clement, letter.
TEAM, Wheaton, Ill., Ronald A. Brett, letter.
Temple Sholom, Chicago, Ill., Richard Katz, letter.
Texas Presbyterian Foundation, Dallas, Tex., Louis M. Dunklin, letter.
Thayer Academy, Braintree, Massachusetts, Eileen B. Cutler, letter.
Toccoa Falls College, Toccoa Falls, Ga., Neil E. Veydt, letter.
Trans World Radio, Chatham, N.J., Timothy Klingbeil, letter.
Truett-McConnell College, Cleveland, Ga., Jessie White, letter.
Tulane University, New Orleans, La., Leslie A. Collins, letter.
Twin Towers, Cincinnati, Ohio, John E. Dunham, letter.
Union College, Lincoln, Neb., John Wagner, letter.
Union Theological Seminary, Richmond, Va., James T. Womack, letter.

United Cerebral Palsy of Southeastern Wisconsin, Inc., Milwaukee, Wis., Joyce Altman, letter.
United Church of Christ:
  Commission on Development, New York, N.Y., Donald G. Stoner, letter.
  The Pension Boards, New York, N.Y., John D. Ordway, letter.
  United Church Board for World Ministries, New York, N.Y., Myles H. Walburn, letter.
United Methodist Church Foundation, Inc., Syracuse, N.Y., V. Stewart Underwood, letter.
United Methodist Foundation, Northern Illinois Conference, Inc., Chicago, Ill., Richard L. Heiss, letter.
United Way Endowment/Planned Giving Program, Santa Barbara, Calif., Sally C. Walker, letter.
University of Akron, Ohio, John B. Shorrock, letter.
University of Alabama, Tuscaloosa, Ala., Don L. Atkins, letter.
University of Alaska, Fairbanks, Alaska, Scott Taylor, letter.
University of Arizona Foundation, Tucson, Ariz., Kenneth A. Haber, letter.
University of Arkansas for Medical Sciences, Office of University Development, Little Rock, Ark., Sue S. Williamson, letter.
University of Buffalo Foundation, Inc., Buffalo, N.Y., Joseph J. Mansfield, letter.
University of Chicago, School of Social Service Administration, Chicago, Ill., Mary Jane Keitel, letter.
University of Dayton, Ohio, Cletus E. Oberst, letter.
University of Denver, Colo., Scott R. Lumpkin, letter.
University of Evansville, Ind., Dianne K. Garnett, letter.
University of Mary, Bismarck, N.D., Ernest B. Borr, and Cate Coghlan, letters.
University of New Mexico Foundation, Inc., Albuquerque, Joseph W. Skehen, Donna DeLozier, Charles W. Vickers, and Randall L. Williams, joint letter.
University of Northern Colorado Foundation, Inc., Greeley, Colo., Michael C. Spellman, letter.
University of Northern Iowa Foundation, Cedar Falls, Iowa, Dee Vandeventer, letter.
University of San Diego, School of Law, San Diego, Calif., Elizabeth Stroube Schiff, letter.
University of Tennessee at Chattanooga, Ronald G. Area, letter.
University of the South, Sewane, Tenn., Tom G. Watson, letter.
University of Utah, Salt Lake City, Utah, J. Michael Mattsson, letter.
Valley Baptist Medical Foundation, Harlingen, Tex., F. Joe Snyder, letter.
Valparaiso University, Valparaiso, Ind., Robert V. Schnabel, letter.
Vanderbilt University, Nashville, Tenn., Bronson C. Davis, letter.
Vassar College, Poughkeepsie, N.Y., Sue Peirce Hartshorn, letter.
Vernon Advent Christian Home, Inc., Vernon, Vt., Raymond M. Beecroft, letter.
Villa Maria Academy, Malvern, Pa., Sister Regina Stephen Lavan, letter.
Virginia Baptist Children's Home and Family Services, Salem, Va., Louis R. Cobbs, letter.
Virginia Polytechnic Institute and State University, Blacksburg, Va., W.E. Lavery, letter.
Washington Theological Union, Silver Spring, Md., Rev. Vincent Cushing, OFM, letter.
Webster-Cantrell Hall, Decatur, Ill., Merlin Outcalt, letter.
Wesley Foundation, Wichita, Kansas, Frank M. Burch, letter.
Western Carolina University, Cullowhee, N.C., James L. Medlin, letter.
Western Maryland College, Westminster, Md., H. Hugh Dawkins, Jr., letter.
Western New England College, Springfield, Mass., Alan Hale, letter.
Westminster College, New Wilmington, Pa., Oscar E. Remick, letter.
Westover School, Middlebury, Conn., Cortlandt B. Fengler, letter.
Wheaton College, Norton, Mass., Debra Ashton, letter.
Wheeling Country Day School, Wheeling, W. Va., Richard E. Kammer, Headmaster, letter.
Whittier College, Whittier, Calif., Douglas K. Kinsey, mailgram.

Page

Whitworth Foundation, Whitworth College, Spokane, Wash., Stephen Trefts, letter.
Wilkes College, Wilkes-Barre, Pa., Richard F. Charles, letter.
Willard Library of Evansville, Ind., Martin L. Leich, letter.
Williston Northampton School, Easthampton, Mass., Sally C. Holland, letter.
Winchester-Thurston School, Pittsburgh, Pa., Helen G. Scully, letter.
Wittenberg University, Springfield, Ohio, William A. Kinnison, letter.
Wood, G. Timothy Wood, Gainesville, Fla., letter.
Worcester, Diocese of, Worcester, Mass., Most Rev. Timothy J. Harrington, letter.
Word of Life Fellowship, Inc., Schroon Lake, N.Y., Douglas H. Mieras, letter.
World Radio Missionary Fellowship, Inc., Opa Licka, Fla., Dwite M. McCloud, letter.
YMCA of Metropolitan Chicago, Ill., Marcus T. Young, letter.
York Hospital, York, Pa., H. Charles Hafey, Jr., letter.
Young Men's Christian Association of Metropolitan Detroit, Mich., Kenneth C. Isherwood, letter.
Zenko, John A., Chicago, Ill., letter.

Section 1021:

CNA Insurance Companies, Susan J. Hotine, letter and attachment 927

Section 1023:

Ikard, Frank N., on behalf of a coalition of insurers of nonprofit hospitals, letter and statement 930
The Travelers Corp., Edward H. Bud, statement 936

Section 1031:

Mutual Protection Trust, by Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, statement and attachments 940

TITLE XI—PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS

Comments on more than one section (also includes some Title XVIII):

Alexander, Donald C., Cadwalader, Wickersham & Taft, letter (Sections 1107 and 1122) 951
American Society of Pension Actuaries, Howard Phillips, letter and attachments (Sections 1105, 1106, 1111, 1112, 1114, 1116, 1117, 1122, 1132, 1151, and 1898) 954
Association of Private Pension and Welfare Plans, statement (Sections 1105, 1106, 1111, 1112, 1113, 1114, 1117, 1120, 1131, 1133, 1151, 1174, 1895, and 1898) 960
Brobeck, Phleger & Harison, Barry W. Homer, Patrick J. Foley, Cynthia G. McCabe, and Julie D. Gallagher, joint letter and attachments (Sections 1106, 1107, 1116, and 1174) 965
Committee of Annuity Insurers, Gail Bramblett Wilkins, statement (Sections 1135 and 1826) 974
ERISA Industry Committee, statement (Sections 1111, 1114, 1116, 1117, 1122, 1123, 1124, 1133, 1174, 1175, 1603, 1852, 1895, and 1898) 980
ESOP Association, statement and attachment (Sections 1123, 1132, 1133, 1136, 1172, 1173, 1174, 1175, 1176, and 1854) 997
Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, Norman C. Bensley and Betsy Finn Yegelwel, statement (Sections 1106, 1135, and 1826) 1015
Foster, David S., Brobeck, Phleger & Harrison, letter and attachment (Sections 1106 and 1114) 1017
National Conference of State Legislatures, Hon. Kevin P. Blanchette, State Representative, Commonwealth of Massachusetts Legislature, statement (Sections 1107, 1121, and 1122) 1019
National Coordinating Committee for Multiemployer Plans, Robert A. Georgine, statement (Sections 1106, 1113, 1151, 1851, and 1898) 1022
Noble Lowndes Becker, Marjorie Martin, letter and attachment (Sections 1105, 1106, 1108, 1112, 1114, 1118, 1119, 1122, 1133, and 1898) 1032
Peachtree Benefit Consultants, Ltd., Leonard Levitt, letter (Sections 1106 and 1112) 1036

Page
Profit Sharing Council of America, David L. Wray, statement (Sections 1115, 1117, 1122, 1123, 1133, 1134, and 1175) 1040
Teachers Insurance and Annuity Association, and College Retirement Equities Fund, Felix B. Laughlin, letter (Sections 1105, 1117, 1123, and 1852) 1043

Section 1101:

Universal Pensions, Inc., Theodore K. Rice, letter 1046

Section 1105:

Preston, Thorgrimson, Ellis & Holman, statement and attachment 1147

Section 1107:

American Council on Education, on behalf of American Association of Community and Junior Colleges, American Association of State Colleges and Universities, Association of American Universities, Association of Catholic Colleges and Universities, Association of Jesuit Colleges and Universities, Association of Urban Universities, Council of Independent Colleges, National Association for Equal Opportunity in Higher Education, National Association of College and University Business Officers, National Association of Independent Colleges and Universities, National Association of Schools and Colleges of the United Methodist Church, and National Association of State Universities and Land-Grant Colleges, statement 1055
IPC Pension Companies, Inc., Jeffrey E. Cashman, letter and attachments 1056
National Rural Electric Cooperative Association, Anthony C. Williams, statement 1059
Section 457 Task Force, statement 1061

Section 1108:

Foley, Patrick J., Brobeck, Phleger & Harrison, letter 1072
Pension Rights Center, Amy R. Shannon, letter 1073

Section 1112:

Baird, Holm, McEachen, Pedersen, Hamann & Strasheim, Gary N. Clatterbuck, letter 1075

Section 1114:

American Society of Association Executives, James J. Albertine, submitted by Dan S. Brandenburg, letter 1177
Matsui, Hon. Robert T., a Representative in Congress from the State of California, letter and attachment 1080

Section 1115:

Hopkins & Sutter, Stewart R. Shepherd and Fredric S. Singerman, statement 1084

Section 1117:

Southland Corporation Employees' Saving and Profit Sharing Plan, Stanley C. Simon, letter 1087

Section 1121:

Employees Retirement System of Texas, Clayton T. Garrison, letter 1089
National Council on Teacher Retirement, statement and attachments 1091
Vento, Hon. Bruce F., a Representative in Congress from the State of Minnesota, forwarding letter from James M. Hacking, Public Employees Retirement Association of Minnesota 1099

Section 1122:

Atkins, Thomas P., Smith & Schnacke, letter 1101
Bowen, Richard E., York, Pa., letter 1103
Chevron Corp., Louis Fernandes, Jr., letter and attachment 1104
Cutone, Mrs. Michael, Jr., Pittsburgh, Pa., letter 1108
Jentsch, Theodore W., Kutztown University, Pa., letter and attachment 1109
Morgan, Regina T., Pittsburgh, Pa., letter 1110

Section 1123:

Barlown, Mary C., Cedar Glen, Calif., letter 1111
Fund for Assuring an Independent Retirement, Vincent R. Sombrotto, letter 1112
Marathon Oil Co., Donald V. Moorehead, statement 1114

Page
Oxley, Hon. Michael G., Representative in Congress from the State of Ohio, letter 1116
Pashayan, Hon. Charles, Jr., a Representative in Congress from the State of California, letter 1117

Section 1131:

Financial Institutions Retirement Fund, John W. Bagwill, Jr., letter and attachments 1118

Section 1151:

Matsui, Hon. Robert T., a Representative in Congress from the State of California, letter and attachments 1122

Section 1172:

Jorgensen, Thomas A., Calfee, Halter & Griswold, and Elaine K. Church, Price Waterhouse, joint statement 1127
Regula, Hon. Ralph, a Representative in Congress from the State of Ohio, forwarding letter from Neil Chrystal, Squire, Sanders & Dempsey, on behalf of Frances G. Shoolroy 1131

Section 1173:

Anderson, John T., Lord, Bissel & Brook, letter 1133
First United Bancshares, Inc., Paula J. Metcalf, statement 1136

Section 1174:

Brophy, James E., III, and Charles W. Whetstine, Ryley, Carlock & Applewhite, joint letter 1137
Buck Consultants, Frederick W. Rumack, letter 1138
Huffman Arrington Kihle Gaberino & Dunn, Sheppard F. Miers, Jr., letter 1141
Levie Strauss & Co., David W. Hardee and Howard L. Clemons, letter and attachment 1142
Oklahoma Natural Gas Co., L.H. Enloe, letter forwarded by the Hon. Mike Synar, a Representative in Congress from the State of Oklahoma 1145
Oneok Inc., P.A. Wimpey, letter 1147
Petschek, Evelyn A., and Andrew L. Oringer, Patterson, Belknap, Webb & Tyler, joint letter 1148
Public Service Electric & Gas Co., Parker C. Peterman, letter 1151
Witco Corp., New York, N.Y., Paul M. Feeney, letter 1152

TITLE XII

Comments on more than one section (includes some Title XVIII):

Aegis Insurance Services Inc., John W. Weber, letter and attachment (Sections 1221 and 1241) 1155
Equitable Life Assurance Society of the United States, Metropolitan Life Insurance Co., and the Prudential Insurance Co., of America, Theodore R. Groom and Daniel Horowitz, joint statement (Sections 1201, 1202 and 1221).. 1162
Goldman, Sachs & Co., John E. Chapoton, Thomas A. Stout, Jr., and Christine L. Vaughn, statement (Sections 1221, 1222 and 1223) 1167
Irving Trust Company, statement and attachments (Sections 1201 and 1261) 1172
Klein, Kenneth, Cadwalader, Wichkersham & Taft, letter (Sections 1215, 1235 and 1810) 1180
McIntyre, Michael J., Wayne State University Law School, Detroit, Mich., statement (Sections 1211, 1215, 1221, 2141, 1261 and 1875) 1188
Securities Industry Association, Randall K.C. Kau, letter and attachments (Sections 1221, 1223, 1235 and 1810) 1190

Section 1201:

Advanced Computer Environmental Systems Support, Inc., R.C. Frey, letter 1199
American Express Co., Denise G. Ferguson, letter and attachments 1200
International Business Machines Corp. (IBM), Andrew H. Friedman, letter and attachment 1205
Matsui, Hon. Robert T., a Representative in Congress from the State of California, letter and attachments 1207
Oosterhuis, Paul W., Miller & Chevalier, letter 1216
USG Corp., Paul W. Oosterhuis and Patricia M. Lacey, letter 1220

Section 1211:

Page
Kliegman, Michael J., Lane and Edson, statement 1224

Section 1214:

Matsui, Hon. Robert T., a Representative in Congress from the State of California, letter and attachment 1226
Rosenbloom, H. David, Caplin & Drysdale, letter 1233

Section 1215:

Hercules Inc., Arden B. Engebretsen, letter and attachment 1235
Salmon, John J., Dewey, Ballentine, Busby, Palmer & Wood, letter and attachment 1239

Section 1221:

Alliance of American Insurers, Stephen W. Broadie, letter 1242
Continental Corp., and the Chubb Corp., Walter D. Vinyard, Jr., joint letter 1244
Overseas Shipholding Group, Inc., Donald V. Moorehead, statement and attachment 1250
Sutherland, Asbill & Brennan, and Cahill Gordon & Reindel, joint statement .. 1260
Sutherland, Asbill & Brennan, statement and attachment 126360
Welles, David W., Baker & McKenzie, letter 1265

Section 1235:

Coalition to Exclude Operating Income From the PFIC Provisions, Robert McClory, letter 1267
Granwell, A.W., Cadwalder, Wickersham & Taft, letter 1275
Groom and Nordberg, Carl A., Nordberg, Jr., letter 1278
Machinery and Allied Products Institute, statement 1282
Martin, Hon. Lynn, a Representative in Congress from the State of Illinois, forwarding letter and attachments from Ted Ross, Sundstand Corp 1289
Tax Executives Institute, Inc., Thomas M. Nee, statement 1305
TSG Holdings Inc., Lawrence O'Connell, letter and attachment 1330
United States Council for International Business, Richard M. Hammer, letter. 1333

Section 1236:

Banco Popular de Puerto Rico, Hector Ledesma, letter and attachment 1335

Section 1241 (includes IRC Section 7852:

American Chamber of Commerce in France, George P. Larounis, letter 1344
American Chamber of Commerce in Italy, Michael N. Bitsas, letter 1345
Association of Americans Resident Overseas, Stephanie H. Simonard, letter..... 1346
Financial Executives Institute, James R. Pratt, letter 1348
Institute of Foreign Bankers, Inc., Lawrence R. Uhlick, letter and attachment 1349
National Foreign Trade Council, Inc., Thomas J. DuBos, letter 1354
O'Brien, Lawrence F., III, Dewey, Ballentine, Bushby, Palmer & Wood, letter .. 1355
Peat Marwick Main & Co., Stephen M. Brecher, John Raedel, Aaron Rubinstein, and Ronald Harvey, joint letter 1359
Rosenbloom, H. David, Caplin & Drysdale, letter 1362
United States Council for International Business, Richard M. Hammar, and Robert J. Patrick, Jr., joint letter 1366

Section 1246:

Weigel, William H., Davis Polk & Warwell, letter 1367

TITLE XIII—TAX-EXEMPT BONDS

Comments on more than one section (includes mention of Sections 252 and 902):

Connecticut, State of, Ann I. Sullivan, letter and attachment (Sections 1301 and 1316; also Section 252) 1376
Essex County, N.J., John J. Scally, Jr., statement (Sections 1314 and 1317) 1378
National Association of Bond Lawyers, statement (Sections 1301 and 1313; also Section 902) 1384

Section 1301:

College Construction Loan Insurance Association, statement 1390
Froehlich, Kurt P., Evans & Froehlich, letter (also Section 902) 1393

Page
Karnes, Sam B., Leonard Marsh Hurt & Terry, letter and attachment 1401
Woodridge, Illinois, Village of, Kathleen A. Gregory, letter 1404

Section 1312:

Cincinnati Gas & Electric Company, Columbus and Southern Ohio Electric Company, and Dayton Power and Light Company, Jackson B. Browning, Jr., Squire, Sanders & Dempsey, statement 1405

Section 1313:

Council of Industrial Development Bond Issuers, James J. Hughes, letter (also Section 902) 1411
Texas Housing Agency, Charles L. Almond and Michael A. Jungman, statement 1415

Section 1316:

Business Council of New York State, Inc., Raymond T. Schuler, statement 1418
New York Power Authority, Richard Flynn, statement 1420
Prudential-Bache Capital Funding, William B. James, letter 1424
St. Paul, City of, and City of Minneapolis, Minn., Hon. George Latimer, Mayor of St. Paul, and Hon. Donald Fraser, Mayor of Minneapolis, joint letter 1426

Section 1317:

Andover, Massachusetts, Town of, Daniel J. Piliero II, statement and attachments 1427
Aspin, Honorable Les, a Representative in Congress from the State of Wisconsin, letters (also Section 204) 1432
Atkins, Hon. Chester G., a Representative in Congress from the State of Massachusetts, letter and attachment 1436
Georgetown University, Washington, D.C., T. Byron Collins, S.J., and Samuel Harvey, Jr., joint statement 1438
Howard University, Washington, D.C., Roger D. Estep, letter 1441
Latta, Hon. Delbert L., a Representative in Congress from the State of Ohio, letter and attachments 1442
Moody, Hon. Jim, a Representative in Congress from the State of Wisconsin, Hon. Tom Downey, a Representative in Congress from the State of New York, and Hon. Bob Matsui, a Representative in Congress from the State of California, joint letter (also Section 204) 1447
Morrison, Hon. Sid, a Representative in Congress from the State of Washington, letter 1449
New York Hospital, John P. Glynn, letter 1450
Ravenel, Hon. Arthur, Jr., Hon. Butler Derrick, Hon. Robin Tallon, Hon. Elizabeth J. Patterson, Hon. Floyd Spence, and Hon. John M. Spratt, Jr., Representatives in Congress from the State of South Carolina, joint letter 1452

TITLE XIV—TRUSTS AND ESTATES; UNEARNED INCOME OF CERTAIN MINOR CHILDREN GIFT AND ESTATE TAXES; GENERATION-SKIPPING TRANSFER TAX

Comments on more than one section:

American Bar Association, Section of Real Property, Probate and Trust Law, Pam H. Schneider, letter forwarding comments of individual members (Sections 1431 and 1433) 1454
Cohan, John R., Irell & Manella, letter (Sections 1431 and 1433) 1470
Knowlton, L.L., Arter & Hadden, letter (Sections 1431 and 1433) 1472
New York State Bankers Association, Michael P. Smith, letter (Sections 1403 and 1404) 1477

Section 1402:

Hastings, Dan T., Milbank, Tweed, Hadley & McCloy, New York, N.Y., letter .. 1479

Section 1403:

Marshall & Ilsley Trust Co., Christopher F. Gloe, and John P. Mitchell, letters 1482
Sovran Bank, Trust Division, S.J. Grande, letter 1485
Texas Bankers Association Trust Financial Services Division, Scott A. Blech, letter 1486

Section 1411:

Page
Emboulas, Lawrence A., Pepperman, Emboulas, Schwartz & Todaro, letter and attachment ... 1488
Stonich, Timothy W., Wilmette, Ill., letter ... 1497
Wolpe, Hon. Howard, a Representative in Congress from the State of Michigan, forwarding letter of Roy Pentilla, Lansing, Mich ... 1498

Section 1431:

American Leprosy Missions, Richard R. Hamilton, Jr., letter ... 1501
American National Bank, Robert S. Thedinger, letter ... 1502
Baptist Foundation of Texas, Terry L. Simmons, letter ... 1503
Boy Scouts of America, National Office, Dan A. Leeman, letter ... 1504
Clark University, Worcester, Mass., Richard P. Traina, letter ... 1505
Drexel University, Philadelphia, Pa., Carolyn A. Sprogell, letter ... 1506
East Texas Baptist University, Marshall, Tex., Harvey D. Lewis, letter ... 1507
Foundation of Jewish Philanthropies, Penny Marlin, letter ... 1508
Frantzreb, Arthur C., Arthur C. Frantzreb, Inc., letter ... 1509
Gray, Hon. Elmon T., a State Senator from the Commonwealth of Virginia, letter ... 1510
Gray, Horace A., III, Richmond, Va., letter ... 1511
Horn, Jerold I., Peoria, Ill., letter ... 1512
Little Company of Mary Hospital Foundation, Ron Bitzer, letter ... 1514
Loma Linda University, Calif., George Carambot, letter ... 1515
Lutheran Church—Missouri Synod, D.D. Schiebinger, statement ... 1516
Mid-America Union, Conference of Seventh-Day Adventists, George Woodruff, letter ... 1517
Mirabello, Francis J., Morgan, Lewis & Bockius, letter ... 1518
Mount Sinai Medical Center, Blair Hearth, letter ... 1520
Northfield Mount Hermon School, Mass., Richard F. Odell, letter ... 1521
Pamela O. Price, Gray, Harris & Robinson, Orlando, letter and attachment ... 1522
Rice University, Houston, Tex., Kent E. Dove, letter ... 1525
Rutgers University Foundation, David G. Clough, letter ... 1526
Salvation Army, Headquarters for the Eastern Michigan Division, John G. Fike, letter ... 1527
School of Theology at Claremont, Calif., David H. Nienas, letter ... 1528
Slutsky, Kenneth J., Lowenstein, Sandler, Kohl, Fisher & Boylan, letter ... 1529
Smith, Barbara J., and M. Patricia Culler, Squire, Sanders & Dempsey, joint statement ... 1532
Southern Methodist University, Dallas, Tex., Colin V. French, letter ... 1534
Southwestern University at Georgetown, Tex., Richard B. Eason, letter ... 1535
Texas A&M University Development Foundation, R.M. Rutledge III, letter ... 1536
Thomas Jefferson University, Philadelphia, Pa., Francis J. McGovern, letter ... 1537
United Methodist Foundation in Western North Carolina, Richard D. Bailey, statement ... 1538
United Way Endowment/Planned Giving Program, Sally C. Walker, letter ... 1540
University of Florida Foundation, Inc., Robert R. Lindgren, letter ... 1541
University of Rochester, N.Y., Jack Kreckel, letter ... 1542
University of Tennessee, Charles F. Brakebill, and Joseph E. Johnson, identical letters ... 1543
Wesleyan University, Middletown, Conn., Judy Pillon, letter ... 1544
Whitworth Foundation, Stephen Trefts, letter ... 1545
Zabukovec, Janice J., Shank, Irwin, Conant, Lipshy & Casterline, letter ... 1546

Section 1433:

American Security Bank, N.A., Conservators of the Estate of Virginia Hollerith, by Richard Hollerith, Jr., and Roberta Neilsen, joint statement ... 1547
Balk, Mark D., Goulston & Storrs, letter ... 1548
Bricker, Diane W., and H. Kate Hopkins, Carrington, Coleman, Sloman & Blumenthal, joint letter ... 1550
Christian, Ernest S., Jr., Patton, Boggs & Blow, letter and attachment ... 1554
Harris, W. Gibson, McGuire Woods Battle & Both, letter ... 1560
Latcher, Richard, Kenneth J. Kies, and Calvin B. Kirchick, Baker & Hostetler, joint letter and attachment ... 1561
Roe, Hon. Robert A., a Representative in Congress from the State of New Jersey, forwarding letter and attachments from Brenda Landrum Bingham, Upper Montclair, N.J ... 1570

Page
Simmons, Sherwin P., Trenam, Simmons, Kemker, Scharf, Barkin, Frye & O'Neill, letter and attachment ... 1575

TITLE XV—COMPLIANCE AND TAX ADMINISTRATION

Section 1501:

Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida, letter and attachment ... 1579

Section 1504:

Nicholas, Kenneth R., Nicholas & Co., letter ... 1581
Saunders, Richard J., the Robinson-Humphrey Co., Inc., letter ... 1582
Wyatt, Tarrant & Combs, Thomas J. Luber, letter ... 1584

Section 1511:

Huffaker, John B., Pepper, Hamilton & Scheetz, on behalf of Executors for the Estates of Mary P. Benson and Eleanor P. Morris, statement and attachment ... 1587

Section 1521:

American Escrow Association, James D. Santini, statement ... 1592
American Land Title Association, statement ... 1596
Lagomarsino, Hon. Robert J., a Representative in Congress from the State of California, forwarding letter from Carol Hixenbaugh, Solvang, Calif ... 1598

Section 1541:

Burmaster, Elton L., Niagara Falls, N.Y., letter and attachment ... 1600

Section 1568:

Cleveland, Ohio, City of, Oscar O. Kniceley, letter ... 1602
Toledo, Ohio, City of, Richard E. O'Brien, letter ... 1603

TITLE XVI—EXEMPT AND NONPROFIT ORGANIZATIONS

Section 1603:

Alexander, Donald C., Cadwalader, Wickersham & Taft, letter ... 1604
Children's Medical Center, David S. Weiner, letter ... 1606
Council on Foundations, James A. Joseph, statement ... 1608
Ferguson, Robert H.M., Patterson, Belknap, Webb & Tyler, letter ... 1609
General Electric Pension Trust, Jayne F. Boyle, letter ... 1611
Massachusetts Eye and Ear Infirmary, Ephraim Freidman, M.D., letter ... 1614
Oppenheimer, Jerry L., Mayer, Brown & Platt, letter ... 1615
QualiCorp Inc., John R. Runningen, letter ... 1616
RREEF Funds, Paul Sack, statement ... 1617

Section 1605:

University Patents, Inc., F. David Lake, Jr., statement ... 1627

Section 1608:

National Association of Collegiate Directors of Athletics, Philip R. Hochbert, letter ... 1630

TITLE XVII—MISCELLANEOUS PROVISIONS

Section 1701:

C.I.C. Enterprises, Inc., and Government Program Services, Inc., N. Jerold Cohen, and John J. Salmon, joint statement ... 1634

Section 1703:

A.C.&T. Co., Inc., Adna B. Fulton, letter ... 1637
Acorn Petroleum, Inc., Harlan L. Ochs, letter ... 1638
Atlas Oil Co., Irwin B. Singer, letter ... 1639
B-B-F Oil Co., Inc., William L. Ferren, letter ... 1640
Ballance Oil Co., William H. Ballance, letter ... 1641
Baron-Huot Oil Co., Bruce Huot, letter ... 1642
Beall Oil Co., John B. Beall, letter ... 1643
Belcher Oil Co., Inc., J. Brad Belcher, letter ... 1644
Benedict & Benedict, Inc., Carroll S. Benedict, letter ... 1645

Page
Big Ten Mart, Dennis Corkery, letter 1646
Block Oil Co., Inc., Russell D. Block, letter 1647
Bob Riley Distributors Inc., Bob Riley, letter 1648
Braun Oil Co., Carl J. Braun, letter 1649
Broadus Oil Corp., L. Paul Broadus, letter 1650
Browning Oil Co., Dave Browning, letter 1651
Certified Oil Co., David J. Hogan, letter 1652
Chatham Oil Co., Ben J. Davenport, Jr., letter 1653
Chiles Oil, Inc., W. Bruce Chiles, letter 1654
Cline Oil Co., Inc., Paul S. Cline, letter 1655
Coulson Oil Co., Inc., Michael B. Coulson, letter 1656
Daniel Baker Oil Co., Inc., William A. Hensley, letter 1657
DATAGAS, Inc., R.H. Buchanan, letter 1658
Dickerson Petroleum, Inc., Tom L. Dickerson, letter 1659
Echols Oil Co., Inc., Layman L. Echols, letter 1660
First National Bank, Jasper, Ala., Jack G. Allen, letter 1661
FKG Oil Co., Mike Lowry, letter 1662
Fort Sumter Petroleum Co., L.M. Bradshaw, letter 1663
Francois Oil Co., Richard C. Francois, letter 1664
G&G Oil Co., Dale A. Flannery, letter 1665
Georgia Oilmen's Association, Roger T. Lane, letter 1666
Gerstner Oil Co., Rudy Gerstner, letter 1667
Gulf Coast Petroleum, James D. Francis, Rosemary A. Jenkins, and Randall A. Jones; Baron Oil Co., and PetroMart Inc., Arthur L. Cahoon and James D. Francis; and Ray Distributing Co., Rosemary A. Jenkins, and James D. Francis, identical letters 1669
Guy Williams & Son Inc., Guy W. Williams, Jr., letter 1670
Handley Distributing Co., Elissa V. Handley, letter 1671
Harper Oil Co., Vincent O'Grady, and Albert C. Woodruff, letters 1672
Harriman Oil Co., Inc., Steve H. Kirkham, letter 1674
Hartley Oil Co., Earl L. Hartley, letter 1675
Headlee Oil Co., Inc., James H. Moore, Jr., letter 1676
Hempels Gas & Appliance, Bruce Johnson, letter 1677
Hildreth Oil Co., C. Carroll Hildreth, letter 1678
Holmes Oil Co., William C. Holmes, letter 1679
Hopson Oil Co., Inc., L.F. Nagel, letter 1681
Howard E. Thomas, Inc., Howard E. Thomas, letter 1682
Independent Oil Co., Inc., Larry E. Darnell, letter 1683
Independent Oil Mens' Association of New England, William R. Fortey, letter 1684
Indiana Oil Marketers Association, Inc., L. Jack Stough, letter 1685
J&L Oil, Inc., G.L. Wright, letter 1686
Jahraus Oil, Kevin D. Jahraus, letter 1687
Johnson Petroleum Marketing, Inc., William E. Johnson, letter 1688
Joseph Mahony & Co., Joseph Mahony, letter 1690
Kent Oil, Inc., William B. Kent, letter 1691
Knox Nelson Oil Co., Inc., Knox Nelson, letter 1693
Leslie F. Russell Oil Co., Inc., Jim Russell, letter 1694
Littlefield Oil Co., A.B. Littlefield, letter 1695
Lyden Oil Co., W.G. Lyden, Jr., letter 1696
Lykins Oil Co., Inc., Donald F. Lykins, letter 1697
Martin & Bayley, Mark Bayley, letter 1698
Matthews Brothers Wholesale, Inc., Nelson E. Matthews, letter 1699
McLuckie Oil Co., Donald McLuckie, mailgram 1700
Mid-Missouri Oil Co., C.F. Houghton, letter 1701
Mid-South Sales, Inc., William B. Benton 1702
Niermann Oil Co., Kenneth W. Niermann, letter 1703
Nimocks Oil Co., Inc., A.B. Nimocks, Jr., letter 1704
Norbert E. Mitchell Co., Donald D. Mitchell, letter 1705
Northrup Oil Co., Thomas E. Northrup, letter 1706
Nusser Oil Co., Inc., John F. Nusser, letter 1707
Orbit Oil Co., Jack E. Story, letter 1708
Pace Petroleum Corp., Petroleum Transport Lines, and Risser Oil Corp., Everett M. Westcott, identical letters 1709
Palmetto Petroleum, Inc., Joe M. Schafer, letter 1710
Parent Petroleum, Peter Mancini, letter 1711

Page
Parrish, Hon. Harry J., Member, House of Delegates, Commonwealth of Virginia, enclosing letter from Frank C. Bedell, Virginia Petroleum Jobbers Association 1712
Peninsula oil Co., Inc., Lee H. Lofstrom, letter 1715
Petroleum Marketers Association of America, Phillip R. Chisholm, letter 1716
Petroleum Marketers of Iowa, E.A. Kistenmacher, letter 1719
Petroleum Traders Corp., Michael B. Himes, letter 1720
Ports Petroleum Co., Inc., William C. Ports, letter 1722
R&H Maxxon, Inc., W. Greg Ryberg, letter 1723
R.M. Roach & Sons, Inc., Steven M. Roach, letter 1724
Ram Corp., J.D. Marek, letter 1725
Rask Oil Co., Inc., Lowell Rask, letter 1726
Remote Services, Inc., Gerald E. Wagner, letter 1727
Riiser Oil Co., Inc., David R. Frankhart, letter 1728
Roanoke Oil Distributors, Inc. No. 2, Coy Bowling, letter 1729
Rogers Oil Co., Logan Thomas, letter 1730
Romine Oil Co., Inc., Larry R. Romine, letter 1731
Schilling Petroleum Co., Bruce H. Cross, letter 1732
Simon Oil Co., Inc., Peter W. Barber, letter 1733
Smith Oil Co. of Pendleton, Inc., James D. Smith, Jr., letter 1734
Smith Oil Co., Inc., Varnville, S.C., W.H. Smith, III, letter 1735
Smith-Rogers Oil Co., Inc., W.L. Rogers, Jr., letter 1736
South Carolina Petroleum Marketers Association, David W. Reed; Goldfinch Distributor, Inc., James B. Goldfinch; New Seaboard Petroleum, Ltd., George R. Covington, identical letters 1737
SouthEastern Oil Marketers Association, Thomas L. Osborne and Howard F. Vincent, letters 1739
Spreeman Oil Co., Gerald Spreeman, letter 1746
Sprott Oil Co., Inc., H.P. Sprott, Jr., letter 1747
Spruill Oil Co., Inc., L.C. Spruill, letter 1748
Stockman Oil, Pierce Stockman, letter 1749
Stop-N-Go Madison, Inc., and Rockford Stop-N-Go, Inc., John N. Becker, letter 1750
Tennessee Oil Marketers Association, Marylee Magee, letter 1751
Tioga Petroleum Co., Inc., David T. Cummings, letter 1752
Torch Oil Co., Terry M. Firch, letter 1753
Travelers Petroleum, Inc., Joe F. Brandt, letter 1754
Valley Petroleum, Peter A. Spina, letter 1755
Volta Oil Co., Inc., James S. Garrett, letter 1756
W.H. Bristow, Inc., W.H. Bristow, Jr., letter 1757
Wayne Distributing, Inc., Wayne N. Mesnarich, letter 1758
William C. Pepper, Inc., William C. Pepper, letter 1759
Wilson Gas & Oil Co., Lancaster, S.C., Elizabeth Wilson, letter 1760
Wilson Oil Co., Inc., Auburn, Ala., H.E. Wilson, letter 1761
Wolf Bros. Inc., Kenneth W. Wolf, letter 1762
Worsley Companies, Inc., Roger D. Teague, letter 1764

Section 1706:

Garrett, Randy, Rockford, Ill., letter 1765
Idea Research, Inc., Charles C. Brown, letter 1766
Mexican American Grocers Association, Steven A. Soto, letter 1767
Society of Hispanic Professional Engineers, Hector A. Castillo, letter 1768
Ventre, Andrew J., Ph.D., Huntsville, Ala., letter 1769

Title XVIII—Technical Corrections

Section 1803:

Arthur Andersen & Co., Howard L. Wright, letter 1770
National Bank of Corry, Pennsylvania:
    Clifford J. Buesink, letter and attachment 1771
    H. Martin Keppel, letter and attachment 1773

Section 1807:

Eagle-Picher Industries, Inc., James G. Baird, statement and attachment 1775
Schler, Michael L., Cravath, Swaine & Moore, letter 1777

Section 1808:

Glennon, Robert E., Williams & Jensen, letter 1779

Page
Lilja, Kermit L., Missoula, Mont. letter ... 1783

Section 1825:

Funeral and Cemetery Industry Coalition, Michael L. Pate, letter and attachments ... 1784
Integrated Resources Life Companies, Daniel J. Piliero II, statement and attachments ... 1793

Section 1848:

VanStone, Jack N., VanStone & Krochta, letter ... 1801

Section 1851:

American Society of Association Executives, James J. Albertine, by Dan S. Brandenburg, letter and attachments ... 1802

Section 1852:

Exacto Spring Corp. Profit Sharing Plan, and Exacto Spring Corp. Pension Plan, William J. Heitz and Daniel R. Linsley, statement and attachments, forwarded by the Hon. Philip M. Crane, a Representative in Congress from the State of Illinois ... 1806

Section 1853:

Gephardt, Hon. Richard A., a Representative in Congress from the State of Missouri, letter ... 1811

Section 1879:

Johnson, Jack J., Butz, Hudders, Tallman, Stevens & Johnson, letter ... 1813

Section 1883:

Goldman, Sachs & Co., John E. Chapoton and Christine L. Laughn, statement. 1815

Section 1895:

Lawton, James P., Davis Polk & Wardell, letter ... 1817
Morgan Guaranty Trust Co. of New York, Gail C. Wasserman, letter ... 1819

TECHNICAL CORRECTIONS RELATED TO TAX PROVISIONS IN OTHER LEGISLATION

Superfund Revenue Act of 1986 (TCA Section 201):

International Business Machines Corp., John B. Jones, Jr., letter ... 1821
Man-Made Fiber Producers Association, John J. Salmon, letters ... 1823
Marathon Oil Co., D.A. Beamer, letter and attachment ... 1826

Harbor Maintenance Revenue Act of 1986 (TCA Section 202):

Blaz, Hon. Ben, a Representative in Congress from the Territory of Guam, statement ... 1828
Asia North America Eastbound Rate Agreement, The "8900" Lines, Greece/United States Altantic and Gulf Conference, Israel Eastbound Conference, Isreal Westbound Conference, Mediterranean North Pacific Coast Freight Conference, and the South Europe/U.S.A. Freight Conference, Marc J. Fink, joint letter and attachment ... 1829
Bentley, Hon. Helen Delich, a Representative in Congress from the State of Maryland, and Hon. Bill Archer, a Representative in Congress from the State of Texas, joint letter and attachment ... 1835
Sea-Land Corp., Rebecca J. Berg, letter ... 1839
Transportation Institute, James L. Henry, letter ... 1841

Omnibus Budget Reconciliation Act of 1986 (TCA Section 203):

National Association of Beverage Importers, William Morris, letter and attachments ... 1842

Tax Equity and Fiscal Responsibility Act of 1982:

SmithKline Beckman Corp., statement ... 1858

Title XII
Comments on more than one section (includes some Title XVIII)

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JACKSONVILLE, FL

July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on the
Technical Corrections Bill
of 1987 (H.R. 2636)

Dear Mr. Leonard:

Enclosed herewith is a memorandum containing comments on certain aspect of the technical corrections legislation applicable to group captive insurance companies. We request that this information be included in the printed record.

The major comment is that the proposed legislation does not contain a provision eliminating the application of the branch level tax to group captive insurance companies that are actually engaged in a United States trade or business. The memorandum suggests two solutions to this problem:

(a) amending the election provided in section 953(c) to one that would permit an electing group captive insurer to be treated as if it were a domestic corporation, or

(b) providing an "ordering rule" that would permit "effectively connected income" which is also "related person insurance income" to be treated as "related person insurance income" for purposes of the exemption from the branch level tax provided in section 884(d)(2)(D) of the Code.

If the application of the branch level tax is not eliminated, several technical problems concerning the interaction of the insurance accounting rules and the mechanics of the branch tax must be provided for.

The memorandum is submitted on behalf of Aegis Insurance Services Inc. (AISI), Harborside Financial Center, Plaza Two, Jersey City, New Jersey 07302, which is a registered agent of Associated Electric & Gas Insurance

Services Limited (Aegis), 30 Cedar Avenue, P.O. Box 1179, Hamilton 5, Bermuda. This undersigned, as attorney for AISI and Aegis, has filed a short form registration statement with the Department of Justice. This material will be filed with the Department of Justice where the required registration statement is available for public inspection. Registration does not indicate approval of the contents of the material by the United States Government.

Very truly yours,

John W. Weber

LEBOEUF, LAMB, LEIBY & MACRAE
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
520 MADISON AVENUE, NEW YORK, N. Y. 10022

MEMORANDUM: DATE July 16, 1987

FOR: Mr. Robert J. Leonard, Chief Counsel,
Committee on Ways & Means
FROM: LeBoeuf, Lamb, Leiby & MacRae

SUBJECT: Problems Arising in the Application of Certain Provisions of the 1986 Tax Act to Group Captive Insurance Companies

The interaction of several provisions of the 1986 Tax Reform Act create serious problems for "group captive" insurance companies. If the branch level tax is applied to corporations which are subject to the tax regime imposed by new section 953(c) the Internal Revenue Code of 1986 (the "Code") such corporations would become subject to at least three levels of taxation. This results in a significantly higher tax liability than that imposed on either similar domestic corporations or similar foreign corporations that are not engaged in a United States trade or business.

In Notice 87-50, the Internal Revenue Service took the view that the BLT imposed by new section 884 applies to those group captive insurers which are engaged in a U.S. trade or business and which make the section 953(c)(3)(C) election. That is, IRS takes the view that the exception from the BLT provided in section 884(d)(2)(D) does not apply to "effectively connected income."

If this view prevails the combined impact of the BLT and section 953(c) will be devastating. An electing foreign insurer which follows traditional practice by investing its premiums in Eurodollar securities will virtually always have a substantial BLT liability.[1]

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[1] The mechanics of the BLT apparently were drafted on the assumption that unless the "branch" makes a distribution to the "home office" its increased earnings and profits will generate increased "U.S. net equity" which will defer the tax. This is not the case for most property/casualty insurance companies which invest their reserves and capital in Eurodollars.

As discussed in more detail below, it is particularly inappropriate to impose the BLT on such group captive insurers, and legislation will be necessary to cure the problems created by the application of the BLT in these circumstances.

SUMMARY

1. The BLT is currently being applied to "group captive insurers" which are engaged in a U.S. trade or business and which make the section 953(c)(3) election. Such corporations thus are placed in a worse position than similarly situated domestic insurers or similarly situated foreign insurers not engaged in a U.S. trade or business.

This problem, as well as the other problems raised herein, could be solved by legislation modifying the section 953(c)(3)(C) election to provide that an electing corporation will be treated as if it were a domestic corporation (the "Domestic Election"). Alternatively, it could be solved by legislation providing that the BLT does not apply to "effectively connected income" which also qualifies as "related person insurance income" earned by corporations which make the section 953(c)(3)(C) election (the "Ordering Rule").

2. If the BLT is permitted to apply to group captive insurers, difficult technical questions arise. These include how the reduced deductions for unearned premium reserves and for loss reserves should be taken into account in calculating "U.S. net equity", and whether earnings and profits attributed to income generated by loss reserve discounting which is exempt from tax pursuant to the "fresh start" should be subject to the BLT. Legislation will be required to smooth these anomalies.

ANALYSIS AND PROPOSED SOLUTIONS

A. BLT Issues.

1. The BLT Should Not Apply. It is not clear that, as a matter of sound tax policy the BLT should be applied to a foreign corporation to the extent it is owned by U.S. persons.[2] This question becomes even more debatable in the circumstances under consideration in view of the premise underlying the enactment of new section 953(c), *i.e.*, that group captive insurers should be taxed as if they were domestic corporations.

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[2] The purpose of the BLT is to treat U.S. branches of foreign corporations as if they were U.S. subsidiaries and to impose a tax equivalent to the withholding tax on dividends. Implicit in this theory is the assumption that if income can be shifted from the "branch" to the "home office" it will not again be subject to U.S. income tax. Such an assumption is obviously incorrect in the case of a foreign corporation owned by U.S. shareholders. This point was recognized in the House Bill which provided a credit to U.S. shareholders for their share of the branch profits tax upon a distribution by the foreign corporation.

If the BLT is applied to a group captive insurer that is actually engaged in a U.S. trade or business, the income of the group captive is subject to at least three levels of tax, i.e., the corporate tax, the BLT, and tax at the shareholder level (often without a dividends received deduction under new section 245).[3] There is a fourth level of tax if the Federal insurance premiums excise tax is deemed to apply.[4] In contrast, the income of a domestic corporation owned by the same shareholders would be subject to two layers of tax i.e., one tax at the corporate level and one at the shareholder level (with the dividends received deduction always available). A similar foreign corporation which was not engaged in a U.S. trade or business would be subject only to one tax at the shareholder level if it did not make the section 953(c)(3)(C) election.[5] Such a disparity in treatment is inconsistent with both the policy implemented through the election and with sound tax policy in general.

In significant instances, U.S. corporations needing insurance have formed foreign insurers because domestic insurance laws would not permit the formation and operation of a domestic carrier in the manner required by business necessities. To adequately serve their insureds, some of these insurers have formed U.S. offices, entered contracts with U.S. agents, or otherwise conducted their activities in ways requiring substantial U.S. contacts.

The statute should not apply in a way that imposes tax penalties on corporations which are required by non-tax regulatory constraints to be domiciled in offshore jurisdictions, and which, in order to serve their domestic policyholders, either consciously (or inadvertently) become engaged in a U.S. trade or business. These carriers should not be taxed more heavily than both their foreign and domestic counterparts.

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[3] Section 245 was amended by the 1986 Act to provide a dividends received deduction with respect to dividends paid by a foreign corporation from "effectively connected income" only to 10 percent shareholders.

[4] The reasoning that causes the exemption from the BLT contained in section 884(d)(2)(D) to be inapplicable to "effectively connected" RPII would also seem to render inapplicable the excise tax exemption contained in section 953(c)(3)(D)(ii).

[5] Subsequent "dividend" distributions would not attract tax at the shareholder level by virtue of section 959.

2. Proposed Legislative Solutions. A legislative solution[6] specifically tailored to group captive insurers is to modify section 953(c)(3)(C) to provide the Domestic Election. In effect, the electing corporation would agree to become subject to U.S. tax on its worldwide income in exchange for relief from the BLT problem. It is notable that the dividends received deduction problem, and the Federal excise tax problem briefly referred to herein would also be eliminated.

A second legislative solution, which would have a more limited effect, is to provide the Ordering Rule.[7] Obviously, "effectively connected RPII" cannot be taxed twice and an ordering rule is required to determine whether the income should be taxed under section 882 and excluded from taxation by virtue of the section 953(c)(3)(C) election, or conversely. Thus, legislation providing an ordering rule treating RPII as within the scope of the section 953(c)(3)(C) election would be appropriate. It would not per se exempt group captive insurers from the BLT. The tax would still apply to the extent that, for example, the foreign corporation provided insurance to non-shareholders or to foreign shareholders, as income attributable to that insurance would not constitute RPII.

B. Technical Problems in the Application of the BLT.

1. Insurance Accounting Issues. If the BLT is to be applied to corporations subject to section 953(c), several problems raised by the 1986 changes to the insurance accounting rules that must be addressed. These problems, in particular the "fresh start" issue discussed below, will require special legislative solutions unless the BLT problems discussed in section A above are cured.

First, sections 832(b)(5) and 846 require loss reserves to be discounted for purposes of calculating underwriting profits. This raises two questions. The first is whether reserves established for "claims made but not paid" or for "incurred but not reported losses" should be treated as "liabilities" for purposes of the U.S. net equity calculation.[8] If so, then a determination must be made as to whether the amount of such liabilities is their full value or their discounted value pursuant to section 846.

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[6] Presumably, the position expressed in Notice 87-50 is based on section 952(b) which provides that effectively connected income may not be characterized as Subpart F income. This position is not required by the statute. Section 953(c)(1) provides that "[f]or purposes of taking into account "related person insurance income" the 10 percent test for a United States shareholder and the 50 percent test for a "controlled foreign corporation" ("CFC") are modified. Section 953(c)(2) defines "related person insurance income" (without reference to section 952(b)), and section 953(c)(3)(C) provides that if the election is made the corporation will not be a CFC by virtue of the section 953(c)(1) rule. Section 952(b) does not exclude "effectively connected income" from characterization as RPII.

[7] This solution would also solve the excise tax problem referred to above.

It is clearly inappropriate to treat the full value of a loss reserve as a liability for BLT purposes. The statute provides that only the discounted value can be taken as a deduction. It would also be unsound policy to take the position that the "discount" creates underwriting profits which, in turn, create a contingent BLT and that 200 percent of this amount[9] must be covered with U.S. assets to defer the liability.

A second accounting problem that arises in connection with the new provisions requiring that loss reserves be discounted results from the transitional rule. Generally, the 1987 opening balance is the discounted value of the 1986 ending balance.[10] Income generated by this reduction in reserves is not required to be taken into "discount" is exempt from tax pursuant to a "fresh start" rule. However, the statute specifically provides that this fresh start discount generates earnings and profits. Act, section 1023(e)(2) and (3). Thus, unless some relief is provided such earnings and profits would be subject to the BLT even though the "income" they represent would not be subject to income tax.

Legislation to mitigate this effect would clearly be appropriate unless legislation eliminating the effect of the BLT on group captive insurers were enacted. Such legislation would be very similar in concept to the amendment proposed in section 112(h)(6) of the Technical Corrections Bill of 1987.

It is not clear that the amendments to section 884(b)(2) contained in section 112(o) of the Technical Corrections Act address these problems. Those amendments exclude pre-1987 earnings and profits from the BLT. The discounting rules and the rules discussed below regarding amortization of the unearned premium reserve would create 1987 earnings and profits with respect to reserve items established in 1986 by requiring, in effect, that a portion of 1986 reserves be taken into income in 1987. Both "fresh start" earnings and profits and those resulting from income generated because of 1986 reserve strengthening are actually generated with respect to transactions that took place prior to the 1987 tax year (*i.e.* the effective date of the BLT) and thus should not be treated as subject to the BLT.

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[8] The question whether loss reserves and unearned premium reserves should be treated as "liabilities" for tax purposes has implications beyond section 884. It is closely related to the question whether section 832 or 108 applies to the write-off of reserves of an insolvent insurance company. Several years ago, IRS was asked to rule on these issues, but, to date, has not done so.

[9] The discount would have to be covered once because the undiscounted value of the reserve was treated as a liability, and a second time to generate a sufficient increase in U.S. net equity to cover the underwriting profits.

[10] This reserve reduction is not permitted for "reserve strengthening" that took place in 1986.

A third accounting problem is the treatment of the unearned premium reserve. For tax years beginning after December 31, 1986, a deduction is allowed for only 80 percent of increases to the unearned premium reserves. Further, 20 percent of the closing balance of that reserve for the 1986 tax year is taken into account ratably over six years. The tax accounting for this reserve raises the same questions as those raised with respect to the loss reserve discounting rules and requires a similar solution.

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July 17, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
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RE: Comments on International Insurance Tax Aspects of H.R. 2636

Dear Mr. Leonard:

This statement concerning H.R. 2636, The Technical Corrections Act of 1987, is being submitted for the record on behalf of The Equitable Life Assurance Society of the United States, Metropolitan Life Insurance Company and The Prudential Insurance Company of America.

The Tax Reform Act of 1986 ("1986 Act") made extensive changes in the taxation of foreign operations of U.S. insurance companies and their subsidiaries. For the reasons discussed below, certain provisions affecting these operations should be clarified or revised. We respectfully request that our proposals be incorporated into H.R. 2636.

1. Investment Income Attributable To Same-Country Insurance Should Not Be Subject To Subpart F.

Subpart F of the Code currently taxes certain income of a controlled foreign corporation ("CFC") to the CFC's U.S. shareholders. One component of subpart F income is "insurance income." As defined in section 953 (after amendment by the 1986 Act), insurance income essentially is income attributable to the insuring of risks arising outside the CFC's country of incorporation. Therefore, insurance income does not include income attributable to the insuring of risks arising within the CFC's country of incorporation ("same-country insurance"). Under prior law, also, section 953 did not apply to same-country insurance income, because that section applied only to the insurance of U.S. risks.

Notwithstanding the rules of section 953, the 1986 Act has made a substantial portion of the income attributable to same-country insurance subject to subpart F. Under section 954(c), foreign personal holding company income -- another component of subpart F income -- now includes all investment income derived by an insurance company, even investment income attributable to same-country insurance. Prior law's exceptions for investment income derived on ordinary and necessary reserves and certain surplus were repealed without regard to whether the income is attributable to same-country insurance.

We believe that the 1986 Act change which applies subpart F to investment income attributable to same-country insurance is inappropriate for the following reasons:

- The earning of investment income is an integral part of the business operations of insurance companies. Premiums are received and invested in order to satisfy benefit claims and other insurance expenses incurred by the company. Thus, the various aspects of an insurance policy are an integrated economic transaction, and investment income is properly viewed as a component of insurance income. Accordingly, when investment income is attributable to same-country insurance, this investment income should continue to be excluded from subpart F as is the case for the same-country insurance income under section 953.
- Maintaining this prior law exclusion for investment income would be consistent with the base company concept of subpart F. Under this concept, subpart F is generally applied only to income that is derived from operations outside the CFC's country of incorporation. See section 954(d) and (e), relating to foreign base company sales and services income.
- Allowing deferral for all types of income attributable to same-country insurance would permit U.S.-owned foreign insurance companies to compete abroad under the same tax burdens that apply to non-U.S.-owned foreign insurance companies. Equalizing this competition for foreign markets would benefit U.S. companies seeking to expand abroad and would help reduce U.S. trade and balance of payment problems.
- The exclusion from subpart F of all income attributable to same-country insurance would not be subject to abuse. If risks were reinsured into a tax-haven affiliate, subpart F would apply to eliminate deferral.

Accordingly, H.R. 2636 should provide that foreign personal holding company income does not include investment income attributable to same-country insurance.

2. If Investment Income Attributable To Same-Country Insurance Is To Be Subject To Subpart F, (i) Deductions Should Be Allowed For Reserves, Benefits, Policyholder Dividends and Other Expenses, and (ii) Deficits Should Be Carried Forward Against Future Subpart F Income.

i. Deductions

Subpart F taxes U.S. shareholders only on the net income of a CFC after allowance of deductions for expenses of the CFC that are properly allocable to its gross subpart F income. Section 954(b)(5). Accordingly, if, notwithstanding the arguments set forth above, the decision is made to apply subpart F to investment income attributable to same-country insurance, the expenses properly allocable to this investment income must be determined and allowed as a deduction.

In applying subpart F, the deductions for benefit payments, reserves, policyholder dividends and other insurance expenses should not be allocated first to premium income of an insurance CFC. Instead, these deductions should be allocated between the company's gross investment income and gross premium income in a manner that is consistent with the contribution these expenses make to the production of both types of income. In many cases, it will be appropriate to allocate these expenses between investment and premium income on a pro rata basis. In some situations, however, a direct tracing or other allocation method may be appropriate.

Only such a pro rata or other allocation of expenses reflects the fact that an insurance company effectively derives both its premiums and investment income in exchange for its provision of insurance, so that costs of providing insurance -- such as reserves and benefit payments -- contribute to the production of both classes of income. Policyholders pay premiums at the beginning of the period covered by the insurance, and the company uses the investment income earned on these premiums, as well as the premiums themselves, to provide the insurance coverage. For this reason, reserves, benefit payments, policyholder dividends and other expenses of providing insurance are a necessary factor in the production of the company's investment income and should be partly allocated thereto. Moreover, the partial allocation of these insurance expenses to investment income is consistent with the proper method of cost allocation for other financial intermediaries. The contrary method of allocating costs of providing insurance only to premium income is conceptually wrong and should be rejected. It is incorrect to assume that reserves, benefit payments, policyholder dividends and other insurance expenses are only costs of producing premium income and not investment income.

Accordingly, H.R. 2636 should be clarified to provide for allocation of benefit payments, reserves, policyholder dividends and other expenses on a pro rata or other appropriate basis in computing the investment income attributable to same-country insurance that is subject to subpart F.

ii. Deficits

Under section 952(c)(1)(B), the subpart F income of a CFC that a U.S. shareholder must include in income is offset by the shareholder's pro rata share of any "qualified deficit" incurred by the CFC in a prior year. In order to be qualified, a deficit must be attributable to the same "qualified activity" as the income being offset. The term "qualified activity" means any activity giving rise to: foreign base company shipping income; foreign base company oil related income; in the case of a qualified insurance company, insurance income; or, in the case of a qualified financial institution, foreign personal holding company income.

As discussed above, under the 1986 Act, investment income attributable to same-country insurance is included in subpart F, foreign personal holding company income. A CFC engaged in same-country insurance activities may incur a deficit from those activities if the amount of gross investment income is less than the properly allocable deductions.

It is not clear that section 952(c)(1)(B) allows such a deficit incurred in same-country insurance activities to be carried forward. Under section 952(c)(1)(B)(iii)(III), in the case of a qualified insurance company, only a deficit incurred in an activity giving rise to "insurance income" can be carried forward. However, if the section 953 definition of the term "insurance income" applies for this purpose, a deficit incurred in same-country activites can not be carried forward because section 953 excludes same-country insurance. Similarly, under section 952(c)(1)(B)(iii)(IV), in the case of a "qualified financial institution," a deficit incurred in an activity giving rise to foreign personal holding company income can be carried forward. However, it is not clear that this provision applies to an insurance company since section 952(c)(1)(B)(iv) includes in the term "qualified financial institution" only CFCs engaged in a "banking, financing, or similar business."

H.R. 2636 should clarify that a deficit incurred in same-country insurance activities can be carried forward and applied to offset any future subpart F investment income from these activities. The general rule of section 952(c)(1)(B) is to allow subpart F income generated by an activity to be offset by prior deficits incurred in that same activity. This general rule should apply to same-country insurance activities as it applies to other activities generating subpart F income.

3. Insurance Reserves For Foreign Operations Should Be Computed Based On The Factors Relevant To Those Operations.

For the first time under the 1986 Act, subpart F applies to certain income a CFC derives from insuring foreign risks of unrelated parties. The computation of this subpart F income requires the determination of insurance reserves which are a deduction from the gross income of an insurance CFC.

Reserves are a measure of the present value of a company's insurance liabilities. A deduction for reserves is provided for insurance companies in order to properly reflect their income.

For insurance operations in the United States, the Code generally bases the determination of reserves on interest rate, mortality, morbidity and expense factors derived from U.S. experience. See sections 807 and 846. It would be illogical, however, to use the same U.S. experience factors to determine reserves for foreign operations since U.S. and foreign interest rates and other experience may be very different.

The present value of foreign insurance liabilities cannot be accurately determined if reserves are based on factors derived from U.S. experience. For this reason, the use of U.S. reserve factors would inevitably overstate or understate the income from foreign insurance operations. Accordingly, it should be clarified that reserves for foreign operations are to be based on factors relevant to those operations rather than on U.S. factors.

4. The Fresh Start For Casualty Insurance Reserves Should Be Excluded From Earnings And Profits In Computing Dividends From A Foreign Corporation And The Indirect Foreign Tax Credit.

The 1986 Act substantially revised the method for computing reserves for casualty insurance companies. The Act gave companies a "fresh start," however, for preexisting reserves. Under the fresh start rules of Act section 1023(e)(3), any decrease in these preexisting reserves resulting from the change to the new method for computing reserves is not included in taxable income but is included in earnings and profits.

The increase of earnings and profits by the fresh start is inappropriate for certain purposes in the international context. Unlike the domestic context, in the international context increasing earnings and profits by the fresh start often increases the amount of total corporate level tax (U.S. and foreign) rather than only the amount of individual shareholder level tax on distributions. H.R. 2636 (section 112(h)(6)) recognizes that such an increase in corporate level tax is contrary to the purpose of the fresh start by providing that the fresh start shall not increase earnings and profits in applying Code section 952(c)(1)(A). The latter provision limits the subpart F income of a CFC to the amount of its earnings and profits.

This rule of H.R. 2636 should also apply to the determination of whether a distribution by a foreign corporation to a U.S. corporation is a dividend and to the determination of the indirect foreign tax credit under sections 902 and 960 with respect to such a dividend. Under sections 902 and 960, a U.S. shareholder that receives an actual or deemed subpart F dividend from a foreign corporation qualifies for an indirect foreign tax credit equal to a portion of the foreign taxes paid by the foreign corporation. This portion is based on the ratio of the amount of the actual or deemed dividend to the amount of the foreign corporation's earnings and profits.

Increasing earnings and profits for purposes of this indirect foreign tax credit computation or for determining whether a distribution to a corporation is a dividend would produce inappropriate results. The indirect foreign tax credit would be diluted, thereby increasing corporate level tax contrary to the purpose of the credit and the fresh start. For instance, there would be residual (after foreign tax credit) U.S. corporate tax if a U.S. corporate shareholder received an actual or deemed dividend from a foreign casualty insurance company that is subject to an effective rate of foreign tax equal to the U.S. effective rate. It is contrary to the purpose of the indirect foreign tax credit and the fresh start, however, to impose residual tax in this situation. There should be no residual U.S. tax when the United States and a foreign country are taxing income at the same effective rate. Moreover, if the fresh start increases earnings and profits and therefore residual tax, the change in method for computing casualty reserves will also increase corporate level tax with respect to preexisting reserves. This is the very result the fresh start was designed to avoid. The inappropriateness of this result is underscored by the fact that it does not occur if a U.S. casualty company operates in a foreign country through a branch rather than a subsidiary.

Accordingly, H.R. 2636 should be revised to provide that the fresh start does not increase earnings and profits for purposes of determining whether a distribution to a U.S. corporation is a dividend and of computing the indirect foreign tax credit under sections 902 and 960 with respect to such a dividend. However, earnings and profits would be increased by the fresh start for purposes of determining whether a distribution to an individual is a dividend.

We would welcome the opportunity to work with staff to resolve these issues and will submit additional materials expanding upon the above discussion as appropriate. Please call if you have any questions.

Very truly yours,

Theodore R. Groom

Theodore R. Groom

Daniel Horowitz

Daniel Horowitz

This statement is submitted by John E. Chapoton, Thomas A. Stout, Jr. and Christine L. Vaughn of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of GOLDMAN, SACHS & CO.

Amendment to Clarify Application of Subpart F to Certain Partners in U.S. Partnerships

[Code §§951, 954, and 702;
Tax Reform Act §1221, 1222, and 1223]

Background

Under the provisions of Subpart F, a United States person may be required to include in gross income certain kinds of income earned by a controlled foreign corporation, even though not distributed. The application of Subpart F is limited to "United States shareholders" -- United States persons who own, or by attribution are considered as owning, at least 10 percent of the total combined voting power of the voting stock of a foreign corporation. Congress deemed it inappropriate to require recognition of the undistributed earnings of a foreign corporation by U.S. taxpayers with a relatively small interest in and only limited ability to control the policy of a foreign corporation, especially the policy with regard to distributions of earnings. In determining ownership of a CFC, the attribution rules of Code §958 apply. A partner in a U.S. partnership is thus deemed to own for purposes of Subpart F a proportional share of the stock of a foreign corporation owned by the partnership equal to the partner's interest in the partnership.

The Code does not make it sufficiently clear that Subpart F does not apply to a taxpayer whose only interest in a controlled foreign corporation ("CFC") is by attribution from a partnership and whose proportional interest in the CFC stock owned by the partnership is less than 10 percent. 1/ Such a partner is not a "United States shareholder" within the meaning of Subpart F. Furthermore, the interest of such a partner in the earnings of the CFC is relatively small, and the control that such a partner can exercise over corporate policy of the CFC by virtue of his partnership interest is as attenuated as that of any other shareholder with less than a 10 percent interest in the CFC. Nor is such a partner permitted to make an election under Code §962 in order to obtain a foreign tax credit for taxes paid by the CFC because that provision is limited to individuals who are United States shareholders. Thus, application of Subpart F under these circumstances is generally inconsistent with the policy and statutory scheme of Subpart F. However, where a partnership is a United States shareholder, an argument could be made that Subpart F income flows through the partnership to all of its partners, no matter how small their interest.

Proposed Clarifying Technical Correction

Code §§951(a) and 702 should be amended to clarify that a partner in a U.S. partnership is not required to include Subpart F income with respect to stock of a foreign corporation owned by the partnership unless the partner is a "United States shareholder" within the meaning of Code §951(b).

Reasons for Amendment

I. The Statutory Pattern

Section 951(a) requires that a "United States shareholder" include in gross income a pro rata share of the Subpart F income of a CFC. The term "United States shareholder" is defined in section 951(b) to mean

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1/ Nor has any administrative or judicial precedent been found on this issue.

> a United States person (as defined in section [957(c)]) who owns (within the meaning of section 958(a)), or is considered owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

Section 958(b) provides that, in general, the attribution rules of section 318(a) apply to the extent the effect is to treat any United States person as a United States shareholder. A partner in a U.S. partnership is thus considered constructively to own a proportionate share of partnership stock by virtue of section 318(a)(2)(A).

Applying these rules, if a partner owns a one-percent interest in a domestic partnership that in turn owns 100 percent of the voting stock of a foreign corporation, that partner is considered to own only one percent of the stock of the foreign corporation. Thus, such a one-percent partner is not a United States shareholder within the meaning of section 951(b). And it therefore follows that such a one-percent partner is not required to include Subpart F income in his gross income because section 951(a) is limited in its application to "United States shareholders":

> In General. -- If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends -- [his pro rata share of the Subpart F income of the CFC].

Code §951(a)(1) (emphasis added).

It is true that a domestic partnership that owns 100 percent of the voting stock of a foreign corporation is itself a United States shareholder. 2/ But Subpart F income is not an item of partnership gross income a distributive share of which a partner is specifically required separately to include in his gross income under section 702 and Treas. Reg. section 1.702-1(a)(1)-(8). And, as discussed below, to require an inclusion of partnership Subpart F income by a partner considered to own less than 10 percent of the voting power of a foreign corporation would not only conflict with the plain meaning of section 951(a)(1), but also would be fundamentally inconsistent with the policy and legislative history of Subpart F.

The conclusion that such a partner is not required to include any Subpart F income is borne out by the similarly

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2/ The term "United States person" is defined in section 7701(a)(30) to include U.S. partnerships. Therefore, a partnership that owns 100 percent of the voting stock of a foreign corporation is a United States shareholder within the meaning of section 951(b). See note 4, *infra*, for a discussion of the relevance of this classification.

restricted scope of section 962. Section 962 is an elective relief provision for noncorporate taxpayers required to include Subpart F income. Under section 962, a "United States shareholder who is an individual" may elect to be taxed as a corporation and thus receive a section 960 foreign tax credit for foreign income taxes paid by a CFC attributable to Subpart F income. The express purpose of section 962 was to ensure that an individual with a direct investment in a CFC would not bear a heavier tax burden under Subpart F than would an individual investor in a U.S. corporation doing business abroad. S. Rep. No. 1881, 1962-3 C.B. 703, 798 (Senate Report on Revenue Act of 1962). Yet, if an individual partner considered to own less than 10 percent of a CFC were required to include in income his share of partnership Subpart F income, such a partner would not qualify to make the election under Section 962, and so would be required to bear a heavier tax burden. If Congress had intended such a partner to include in gross income the Subpart F income of a CFC, it would not have limited section 962 to 10-percent United States shareholders who are individuals, but would have included either partnerships themselves or individual partners considered to own less than 10 percent of the voting power of a CFC. The fact that Congress did not do so is clear evidence it never intended that such partners include Subpart F income in their gross income. 3/

II. Policy Considerations

The purpose of the 10-percent threshold for inclusion of Subpart F income is to limit application only to taxpayers who have a substantial interest in a foreign corporation and who are capable of exercising active and effective control over corporate policy, especially the policy with regard to utilization of corporate earnings. The House Report on the Subpart F provisions of the Revenue Act of 1962 explained the 10-percent test in this way:

> This *de minimis* rule prevents the attribution of undistributed income back to the shareholders where their interest is small and their influence on the corporation's policy is presumably negligible. The 10-percent ownership test is determined by applying stock ownership attribution rules set forth in the bill.

H. Rep. No. 1447, 1962-3 C.B. 405, 463.

An individual partner cannot exercise unfettered control over partnership property, including stock of a foreign corporation owned by the partnership. Instead, an individual partner's control over partnership property is limited to his beneficial (and voting) interest in the partnership; the other partners have similar rights and can also exercise control equal to their respective beneficial interests. As a result, the derivative control an individual partner can exercise over a foreign corporation

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3/ A contrary view of Subpart F would require an amendment to Code §962 to permit a partner with less than a 10 percent interest in a CFC the option to elect to be taxed as a corporation and receive a section 960 foreign tax credit. Such an amendment would be essential to place such partners on an equal footing with individual United States shareholders of controlled foreign corporations who clearly have Subpart F income.

through the partnership is equivalent to the individual partner's proportional share of that stock. A partner whose voting interest in a partnership is less than 10 percent thus cannot as a result of that interest exercise the same control over a CFC wholly owned by the partnership as a person who owns 10 percent or more of the voting stock of a foreign corporation.

In this regard, consider the example of two partnerships, P1 and P2, each owning 100 percent of the stock of a foreign corporation (FC1 and FC2, respectively). P1 has 100 equal partners, and P2 has 5 equal partners. Clearly, each of the P2 partners has a substantially greater degree of control over FC2 than any one of the P1 partners has over FC1. Moreover, if P1 and P2 distributed pro rata to their partners the stock of FC1 and FC2, the P1 partners each would receive only 1 percent of the stock of FC1, while the P2 partners each would receive 20 percent of the stock of FC2. In this latter case, the P1 partners would not be U.S. shareholders of FC1 (assuming no attribution of stock ownership between partners), while the P2 shareholders would be U.S. shareholders of FC2. The fact that the stock of FC1 and FC2 is held by P1 and P2 instead of by their partners should not obscure the fact that, on the individual partner level, the degree of voting control is the same as it would be if the stock of FC1 and FC2 were owned directly.

This limitation on an individual partner's control over a corporation in which the partnership owns an interest was recognized by Congress and reflected in the Subpart F attribution rules. Section 958(b) generally incorporates the constructive ownership rules of section 318 for purposes of applying the definition of a "United States shareholder." Section 318(a)(2)(A), of course, clearly provides that stock owned by a partnership is considered as owned by its partners in proportion to their respective beneficial interests in the partnership. The section 318 constructive ownership rules have been part of the Code since 1954, Pub. L. No. 83-591, §318 (1954); see H.R. Rep. No. 1337, 1954 U.S. Code Cong. & Ad. News 4025, 4061, 4234-35; S. Rep. No. 1622, 1954 U.S. Code Cong. & Ad. News 4621, 4890-91, and they are the rules now generally applied to determine control of a corporation for a variety of purposes. Although the application of the section 318 rules is sometimes modified to adapt them to varying statutory schemes and policies, we are aware of no instance in which the partnership proportional attribution rule has been altered. 4/ The congruence of the proportional attribution concept with actual control of a corporation is thus universally recognized in the Code.

Fundamental fairness issues would be confronted if partners with de minimis derivative interests in a foreign corporation were required to include in gross income a portion of the corporation's undistributed earnings. The legislative history of Subpart F shows that Congress was very concerned that the imputation of undistributed corporate earnings to U.S. taxpayers might well violate the

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4/ Section 958(b)(2) does modify the entity attribution rules to provide that a partnership, trust, estate, or corporation that owns 50 percent of the combined voting power of a foreign corporation shall be considered as owning all of the stock entitled to vote for purposes of applying the definition of a "United States shareholder." The effect of section 958(b)(2) may thus be to increase the constructive ownership share of an individual partner. The proportional allocation rule itself is not modified, however.

due process clause of the U.S. Constitution. Testimony on this issue was taken by the Ways and Means Committee. Hearings Before the House Committee on Ways & Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess. 309-318, 340-42 (1961) (testimony of Treasury Secretary C. Douglas Dillon). And the Treasury Department was commissioned to prepare a memorandum of law. Id. at 313, 316-18 (Treasury memorandum on constitutionality of proposed Subpart F). The upshot was that the 10 percent voting control requirement was viewed as a minimum threshold consonant with fundamental fairness. Without at least that degree of control over corporate policy with respect to the application of earnings, it would be unfair to tax earnings before they are received by the taxpayer. It would be inconsistent with the policy reflected in the 10 percent threshold to impute Subpart F income to partners with derivative interests that do not cross that threshold, and indeed may be negligible as there would be no minimum interest of a partner that could not be affected.

III. Tax Reform Act of 1986

Sections 1221, 1222, and 1223 of the Tax Reform Act of 1986 greatly expanded the categories of Subpart F income, and the exceptions to Subpart F were tightened or eliminated entirely. At the same time, the indirect credit and Subpart F foreign tax credit provisions were amended to alter the method for determining a U.S. shareholder's share of taxes paid by a CFC. The changes made by the 1986 Act, in creating new types of Subpart F income, have potentially caused these provisions to apply to many companies for the first time. For example, prior to 1987 foreign income of an active banking business was exempt from Subpart F. In repealing this exemption, the 1986 Act could potentially cause for the first time the application of Subpart F to partners in U.S. partnerships engaged in an active banking business through a foreign corporation.

IV. Conclusion

Sections 951(a) and 702 should be clarified to provide that they do not require the inclusion of Subpart F income of a foreign corporation by a partner in a domestic partnership unless that partner is himself a United States shareholder of the foreign corporation within the meaning of section 951(b). 5/

5/ It should be noted that the classification of a partnership as a United States shareholder is still meaningful, even though partners who are not themselves United States shareholders do not include Subpart F income. There are two requisites in section 951(a)(1) for inclusion of Subpart F income: status as a 10-percent shareholder (directly, indirectly, or by attribution) and actual ownership of stock. A partner with a 10-percent derivative interest in a CFC through the partnership is a United States shareholder but would not himself be required to include Subpart F income attributable to that 10-percent interest. Instead, that Subpart F income is included in partnership gross income because the partnership owns the stock, and the Subpart F income is then allocated to a partner who is also a United States shareholder in proportion to his interest in the partnership. The point here is that there is no inclusion of partnership Subpart F income by a partner who is not a United States shareholder.

STATEMENT SUBMITTED ON BEHALF OF IRVING TRUST COMPANY ON THE TECHNICAL CORRECTIONS ACT OF 1987

This statement is submitted on behalf of Irving Trust Company ("ITC") to comment upon the proposed Technical Corrections Act of 1987, making technical corrections to the Tax Reform Act of 1986 (the "1986 Act"). We appreciate the opportunity provided by the Committee to comment upon this important legislation.

The purpose of this statement is to propose additional amendments to provisions of the 1986 Act which have adversely affected ITC's foreign operations.

A. Election to Use the Dollar as Functional Currency

The 1986 Act substantially changed the methods which could be utilized by taxpayers to translate income earned abroad into U.S. dollars.

Section 986(a) of the Code, added by the 1986 Act, provides that a foreign corporation which does not use the dollar as its functional currency shall determine its earnings and profits ("E&P") for U.S. tax purposes using its functional currency and translate the amount so determined into U.S. dollars using the weighted average exchange rate for the taxable year. Similar rules are provided for the translation of income earned through a foreign branch of a U.S. taxpayer which is treated as a qualified business unit ("QBU"). Calculation of E&P in this fashion, which is customarily referred to as the "profit-and-loss method," does not take into account any exchange gain or loss until distributions are made by the foreign unit to U.S. taxpayer.

Under generally accepted accounting principles used in preparing audited financial statements, annual earnings of foreign entities are translated by using their functional currencies (the profit-and-loss method) except in the case of entities operating in highly inflationary economies.* In such case, generally accepted accounting principles employs a method similar to the net worth method in calculating annual income, thereby reflecting inflation.

The functional currency provisions added by the Tax Reform Act of 1986 authorized the Secretary to promulgate regulations permitting a taxpayer keeping its books in a foreign currency to elect the dollar as the functional currency of the QBU or foreign corporation (Code Section 985(b)(3)). The Conference Report to the 1986 Act** stated that the purpose of this election was to address the concerns of taxpayers operating in hyperinflationary economies.

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* Except in the case of high inflation, the annual exchange gain or loss is not included in determining annual net income, but is reported as a separate component of owner's equity. See Statement of Accounting Standards No. 52, Foreign Currency Translation, Financial Accounting Standards Board (December, 1981) (hereafter "FAS 52").

** H. Rep. No. 99-841 (September 18, 1986), pp. II-661 - II-662.

To date, no regulations have been issued implementing this election, and it is not clear when such regulations will be issued.

ITC, like many U.S. banks, is holding debt obligations of Brazil upon which payment has been blocked by the local government. ITC proposes to use some of its blocked Brazilian obligations to acquire stock in a Brazilian bank. Such a transaction would allow ITC to convert these obligations into a profitable investment while at the same time relieving Brazil of some of its foreign debt obligations. It is our understanding that other U.S. banking institutions are considering similar transactions.

At the same time, however, Brazil has historically experienced, and continues to experience, inflation at levels well above 200% per annum. With inflation at such high levels, the amount of taxable income ITC would have to recognize from its Brazilian investment using the profit-and-loss method of translation would be vastly overstated when compared to the actual economic increase of value of its investment. This distortion, caused by inflation, becomes greater as the local inflation rate increases, and is illustrated in the example attached hereto as Exhibit 1.

Thus, absent the availability of an election to utilize the dollar as functional currency, the tax cost to ITC of entering into the proposed transaction is prohibitive. Such an election, which Congress clearly intended to be available in the present circumstances, can only be implemented by regulations. Given the enormous task currently faced by the Treasury Department and the Internal Revenue Service of promulgating regulations implementing the 1986 Act generally, it is impossible to predict when these regulations will be issued. In the meantime, the uncertainty created by the absence of this election makes it impossible for ITC to enter into the proposed transaction.

We propose that an amendment be made to Code Section 985(b)(3) to provide a statutory election for taxpayers operating in hyperinflationary economies to use the dollar as the functional currency. The proposed amendment would permit such an election to be made for a QBU or foreign corporation whose books and records are kept in a "hyperinflationary currency," which is defined as a foreign currency whose value, measured in dollars, declines by 100% or more during the three-year period ending on the on the last day of the taxable year. This is the same standard as that used under generally accepted accounting principles for determining whether inflation is such that the net worth method of translation is appropriate.

In all other respects, the method of translation to be utilized by the taxpayer when the election is made would be as explained in the Conference Report (at pp. II-661 - II-662). Thus, taxpayers would use a balance sheet comparison method utilizing historical costs for all balance sheet items unless regulations authorized the use of other translation methods. While there may continue to be uncertainty as to specific aspects of this translation method, the fact that this election is clearly available for taxable years beginning in 1987 will remove much of the uncertainty of ITC and other banks concerning restructuring of their foreign loans to Brazil and other developing countries experiencing high inflation.

A proposed amendment to section 985(b)(3) is attached hereto as Exhibit 2.

B. Foreign Tax Credit - Separate Limitation for Section 902 Dividends

Section 1201 of the Tax Reform Act of 1986 amended Section 904(d) of the Code by creating several new categories (or "baskets") of income which are treated separately for purposes of computing the foreign tax credit limitation, including the passive income basket, the financial services income basket, and separate baskets for dividends from each noncontrolled Section 902 corporation of the taxpayer. A "noncontrolled Section 902 corporation" means a foreign corporation which is not a controlled foreign corporation (a "CFC") with respect to which the taxpayer owns stock meeting the requirements of Section 902(a) (hereafter a "10-50 corporation").

Where a taxpayer is predominantly engaged in the active conduct of a banking, insurance, financing or similar business, Section 904(d) is unclear as to whether dividends received by the taxpayer from a 10-50 corporation are to be treated as financial services income or as income in the separate basket for dividends from a noncontrolled Section 902 corporation. However, the Joint Committee Staff General Explanation* states that dividends received by such a taxpayer are treated as income in the separate basket for dividends from a 10-50 corporation and not as financial services income. General Explanation, pp. 887-888. Section 112(a)(1)(A) of the proposed Technical Corrections Act of 1987 (H.R. 2636) would codify this result by amending Section 904(d) to explicitly provide that dividends from a 10-50 corporation are not financial services income.

ITC currently owns approximately 40% of the voting stock of a Swiss bank (the "Bank"), an investment which it has held since 1983. At the time of the acquisition of this stock and at all times prior to the effective date of the relevant provisions of the 1986 Act, dividends received by ITC from the Bank were treated as general limitation income under Section 904(d) of the Code and thus were not segregated for purposes of computing ITC's foreign tax credit limitation. In addition, under Section 902 of the Code, ITC was eligible for the deemed-paid foreign tax credit with respect to the dividends received from the Bank.

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* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87 (May 4, 1987) (hereafter cited as "General Explanation").

ITC maintains an active business relationship with the Bank. The Chairman of ITC is a director of the Bank, and many of ITC's foreign operations are conducted through the Bank. No other shareholder has a greater interest in the voting stock of the Bank. If ITC owned more than 50% of the stock of the Bank, it would be a CFC, and its income from the Bank would be financial services income under the look-through rules of Section 904(d)(3). In the case of the Bank, however, the ownership of a majority interest by ITC would result in the Bank no longer being treated as a Swiss bank. Thus, the Bank is, and will continue to be, a 10-50 corporation with respect to ITC.

If the dividends received by ITC from the Bank are treated as income in the separate basket for dividends from a 10-50 corporation, the availability of the deemed-paid credit to ITC will likely be totally eliminated. This is because the interest expense of ITC which must be allocated to its investment in the Bank will probably exceed the amount of dividends paid to ITC, so that the numerator in the separate 10-50 basket limitation will always be zero, and the deemed-paid credits will never be available. In all events, the deemed-paid credit would be drastically curtailed. Furthermore, ITC could not utilize the unabsorbed credits to offset U.S. tax on disposition of the Bank stock, since any gain on that disposition is not 10-50 basket income. The adverse impact on the ability of ITC to use the deemed-paid foreign tax credit with respect to those dividends and the future U.S. tax liability on the sale of the Bank would make ITC's continued holding of its investment in the Bank untenable.

We propose a limited relief measure under which ITC would be permitted to utilize the unabsorbed foreign tax credits on dividends from the Bank solely against its federal income tax liability which might arise from any disposition of stock of the Bank after December 31, 1991. Under our proposal, the tax treatment of dividends received by ITC from the Bank on a current basis would remain unchanged, so that ITC's utilization of direct and deemed-paid foreign tax credit with respect to those dividends would not be changed. However, the excess foreign tax credits resulting from the treatment of the Bank dividends as 10-50 income, as well as deemed-paid foreign tax credits generated by making Section 1248 applicable (as described below), would be available to ITC to offset its federal income tax liability on gain from any disposition of the Bank stock, but only if such disposition occurs after December 31, 1991.

This result is accomplished by bringing the gain on disposition of the Bank stock under Section 1248 of the Code, which recharacterizes gain on disposition of certain foreign corporation stock as a dividend received from the foreign corporation to the extent of the seller's share of undistributed earnings and profits of the foreign corporation. This deemed dividend from the Bank would be treated as foreign source income in the separate basket for 10-50 income, and would carry with it the deemed-paid foreign tax credit attributable to the undistributed earnings. Any additional gain from the sale of the Bank stock will be treated as foreign source income which falls within the 10-50 basket, so that the excess credits from prior years' dividends could reduce federal income tax liability on such gain. In order to assure that the excess credits from prior years' dividends may be so utilized, the bill provides that such credits may be carried forward without regard to the five-year limitation of Section 904(c).

The effect of this proposal would be to permit ITC to utilize its foreign tax credits generated by the Bank against its income from the Bank in the limited circumstances covered by the bill. It would not permit such credits to be utilized against any other income or permit any other credits to be utilized against income from the Bank.

Since this provision would apply only on dispositions after December 31, 1991, there would be no revenue loss during the five-year period beginning in 1987.

A proposed amendment to Section 1201(e) of the Tax Reform Act of 1986 implementing this measure is attached hereto as Exhibit 3.

EXHIBIT 1

Example. Corporation A operates in foreign country X which has as its currency the COB. At the beginning of the taxable year, one COB equals U.S.$0.20, and at the end of the year, one COB equals U.S.$0.10. The weighted average exchange rate for the year is one COB equals U.S.$0.15. At the beginning of the taxable year (which for this purpose is assumed to be A's first year of operations), A's balance sheet in COBS and dollars is as follows:

Beginning of Taxable Year

Assets

	COBs	Conversion Rate	Dollars
Cash and Loans	COBs 40,000	$0.20/COB	$ 8,000
Fixed Assets	10,000	$0.20/COB	2,000
	COBs 50,000		$10,000

Liabilities & Capital

	COBs	Conversion Rate	Dollars
Liabilities	COBs 30,000	$0.20/COB	$ 6,000
Capital	20,000	$0.20/COB	4,000
	COBs 50,000		$10,000

At the end of the taxable year, X's balance sheet is as follows:

End of Taxable Year

Assets

	COBs	Conversion Rate	Dollars
Cash and Loans	COBs 100,000	$0.10/COB	$10,000
Fixed Assets	9,000	$0.20/COB	1,800
	COBs 109,000		$11,800

Liabilities & Capital

	COBs	Conversion Rate	Dollars
Liabilities	COBs 75,000	$0.10/COB	$ 7,500
Capital	20,000	$0.20/COB	4,000
E&P	14,000	Blended Residual	300
	COBs 109,000		$11,800

During the year, X's E&P in terms of dollars had increased by $300. X's E&P measured by using COBs as the functional currency is 14,000 COBs. Using the weighted average exchange rate, as required by present law, of 1 COB = $.15 would result in E&P of $2,100 instead of $300. Thus, on the facts assumed, use of the functional currency profit-and-loss method of computing income results in a seven-times overstatement of E&P.

EXHIBIT 2

[Proposed Amendment]

Section ( ). Section 985(b)(3) of the Internal Revenue Code of 1986 is amended to read as follows:

"(3) Election to Use Dollar as Functional Currency --

(A) In General -- To the extent provided in regulations, the taxpayer may elect to use the dollar as the functional currency for any qualified business unit if --

(i) such unit keeps its books and records in dollars, or

(ii) the taxpayer uses a method of accounting that approximates a separate transactions method.

(B) Special Rule for Hyperinflationary Currency -- The taxpayer may elect to use the dollar as the functional currency for any qualified business unit if the currency in which such unit's books and records are kept is a hyperinflationary currency, and the taxpayer uses a method of accounting that approximates a separate transactions method. For purposes of this subparagraph, "hyperinflationary currency" means currency the value of which, when measured in dollars, declines by 100% or more during the three year period ending on the last day of the taxable year.

(C) Effect of Election -- An election made under subparagraphs (A) or (B) shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

EXHIBIT 3

[Proposed Amendment]

Section ( ) Section 1201(e) of the Tax Reform Act of 1986 is amended by adding at the end thereof new paragraph (4) to read as follows:

(4) Special Rule for Taxpayer Owning Stock in Foreign Banking, etc. Corporation. In the case of [Irving Trust Company], upon any disposition of the stock of [the Bank] which occurs after December 31, 1991 --

(A) gain recognized on such disposition shall be treated as foreign source income described in section 904(d)(1)(E) of the Internal Revenue Code of 1986 (as amended by this section),

(B) section 1248 of such Code shall apply as if [the Bank] were a controlled foreign corporation and the deemed dividend shall be treated as income described in section 904(d)(1)(E) of such Code, and

(C) any foreign income taxes paid or deemed paid by [ITC] with respect to dividends received from [the Bank] which may not be credited by reason of section 904 of such Code shall be treated as paid or deemed paid in subsequent taxable years without regard to the provisions of section 904(c) of such Code limiting the taxable years to which excess foreign tax credits may be carried.

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July 17, 1987

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Chief Counsel
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Subject: Technical Corrections Act of 1987 as it Relates to Passive Foreign Investment Companies

Dear Sir:

Pursuant to Ways and Means Committee press release number 12, dated June 10, 1987, six copies of comments[1] are hereby submitted on the Technical Corrections Act of 1987 (the "Bill")[2] as it relates to the passive foreign investment company ("PFIC") provisions found in sections 1291 through 1296 of the Internal Revenue Code of 1986 ("Code").[3] Set forth below are a series of recommendations for technical changes to the Bill in respect of the PFIC provisions.

RECOMMENDATIONS

I. *Background*

The PFIC provisions were intended by Congress to remove the economic benefit of tax deferral and the ability to convert ordinary income to capital gain which in some instances could be obtained under prior law by U.S. investors who invested in foreign corporations owning assets (such as stock or securities) which produce passive income.[4] The committee reports on the PFIC provisions indicate that such provisions were directed to passive income earned by foreign investment funds.[5] However, the PFIC provisions as enacted are significantly broader than intended and, in many cases, could affect the trading, services, and manufacturing profits of many foreign corporations engaged in active business operations.

Against this background, the drafters of the Bill are to be commended on their efforts to mitigate many of the difficult problems inherent in applying the PFIC provisions to active operating companies, and we believe that most of the technical corrections to the PFIC provisions included in the Bill are needed. However, we also believe that a number of the remaining PFIC provisions are inappropriately harsh when applied to active operating companies and that a number of additional technical corrections are needed.

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[1] The original deadline for comments was July 10, 1987. The deadline was extended to July 17, 1987, by Ways and Means Committee press release No. 15, dated July 7, 1987.

[2] H.R. 2636 and S. 1350, 100th Cong., 1st Sess. (June 10, 1987).

[3] Unless otherwise specified, all section references are to the Code or the regulations thereunder.

[4] H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 393-94 (1986).

[5] *Id.*

II. *DEFINITION OF PASSIVE FOREIGN INVESTMENT COMPANY*

A. *Income Test Applied to Gross Receipts of Corporations Engaged in Active Businesses*

A technical correction should provide that a foreign corporation engaged in the active conduct of a trade or business will meet the income test of section 1291(a)(1) only if 75 percent or more of its *gross receipts* (rather than *gross income*) consists of passive income. This correction is necessary because the gross income test of section 1296(a)(1) results in the passive income earned by a foreign corporation engaged in active manufacturing or sales operations being given proportionately greater weight in the determination of its PFIC status than the sales income from its manufacturing or selling operations since the sales income is reduced by the cost of goods sold in determining gross income for tax purposes.[6]

B. *Asset Test*

1. *Asset Test Should Be Applied to Net Assets*

A technical correction should provide that the asset test of section 1296(a)(2) should be applied to the *net* assets of the corporation (after taking into account liabilities). Application of the asset test of section 1296(a)(2) to the net assets of a foreign corporation would prevent the distortions which might otherwise occur where, as is often the case, a corporation incurs significant debt to acquire assets (whether active or passive).

2. *All Assets Should be Taken into Account at Fair Market Value*

All assets (including intangible assets) of a corporation should be taken into account at their fair market value. Valuation of assets on any basis other than their fair market value (for instance, book value) would result in passive assets being given proportionately greater weight in the determination of a foreign corporation's PFIC status, since the book value of passive assets tends more closely to reflect the actual fair market value of such assets than does the book value of tangible assets associated with active business operations or intangible assets (such as contracts, distribution networks, etc.).[7]

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[6] For example, assume an active manufacturing company sells goods for $200,000,000 where its cost of goods sold is also $200,000,000, resulting in no gross income from the sale of goods. The company also derives $10,000 of passive interest income. Technically, the company is a PFIC.

3. *Assets Which Produce Passive Income*

A technical correction should provide, for purposes of the asset test of section 1296(a)(2), that (i) an asset which produces both passive and non-passive income or receipts will be treated as producing passive income or receipts only to the extent of the ratio of the passive income or receipts produced by the asset to the total gross income or receipts produced by the asset over a time period, and (ii) an asset which does not produce any income will be treated as held for the production of passive income only if the principal purpose of holding such asset is the production of passive income.

C. *Definition of Passive Income*

1. *Section 904(d) Look-Through Rules Should Apply*

A technical correction should explicitly provide that the look-through rules of section 904(d)(3) and (5) apply in determining (i) whether dividends, interest, royalties, and rents received by a foreign corporation from a related person (within the meaning of section 954(d)(3)) constitute passive income or receipts, and (ii) whether the assets giving rise to such income produce, or are held to produce, passive income. Such technical correction should provide that, in cases in which the look-through asset giving rise to such income produces both passive and non-passive income or receipts, such asset should be treated as producing passive income or receipts only to the extent of the ratio of the passive income or receipts produced by the asset to the total gross income or receipts produced by the asset over a time period.[8]

The PFIC rules should not apply to a corporation if it reinvests operating profits through a related corporation, rather than through a branch. Application of the section 904(d) look-through rules would ensure such a result, as was apparently intended by Congress.[9]

2. *Income Derived by Foreign Banks*

A technical correction should exclude from passive income the income derived in the active conduct of a banking, financing or similar business by a foreign corporation doing business under a foreign country's banking or credit laws. As enacted, the exception from passive income for income derived in the active conduct of a banking business requires the exercise of regulatory authority unless the corporation is licensed to do business as a bank in the United States. The uncertainty created by this provision for foreign banks not licensed to do business in the United States potentially places such corporations which are owned directly or indirectly by U.S. persons at a competitive disadvantage vis-a-vis those owned by foreign persons.

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[7] For example, an active operating company might show, on its books, $50 million of active assets and $50 million of passive assets, yet may derive $15 million in income during a year. The passive assets would only be resulting in a $4-5 million income stream. Much of the remaining $9-10 million in income is attributable not only to the $50 million in active assets on the books, but also to intangibles associated with active business' operations not shown on the books.

[8] This rule would not apply to the stock and debt, and dividends and interest with respect thereto, of a 25 percent owned foreign corporation if such assets and income are eliminated under the section 1296(c) look-through rule, discussed below.

[9] *See* Staff of the Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* at 209 (Comm. Print 1987).

3. *Exclusion of Effectively Connected Income*

A technical correction should define passive income to exclude income which is effectively connected with the conduct of a trade or business within the United States unless such income is exempt from taxation (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. (*See* section 952(b)). Neither deferral of tax nor the ability to convert ordinary income to capital gain is available with respect to such income.

D. *Look-Through in the Case of 25 Percent Owned Corporations*

1. *Scope of Application*

A technical correction should provide that the 25 percent owned foreign corporation look-through rule of section 1296(c) applies only to the extent that the effect is to treat a foreign corporation that is otherwise a PFIC (under the general rule of section 1296(a)) as a corporation which is not a PFIC, and does not apply to treat a corporation which is not a PFIC (under the general rule of section 1296(a)) as a corporation which is a PFIC. The look-through rule of section 1296(c) was intended to prevent holding companies formed to own active operating subsidiaries from being treated as PFICs. Under section 112(n)(17) of the Bill, a distribution from, and a disposition of stock of, a lower tier corporation which is a PFIC would be treated as a distribution to, or a disposition by, a United States person treated as owning stock in the PFIC under the attribution rules of section 1297(a), and thus would not escape application of the PFIC provisions if the suggested technical correction were made.

2. *Attribution of Ownership*

A technical correction should provide that, for purposes of determining whether a foreign corporation owns 25 percent (by value) of the stock of another corporation (but not for purposes of attributing income and assets),[10] the indirect and constructive ownership rules of section 267(b), (c) & (f) apply except that in applying section 267(f)(1)(A), "25 percent or more" should be substituted for "more than 50 percent." Unless constructive, as well as indirect, ownership rules are applied for purposes of determining whether a foreign corporation owns 25 percent of another foreign corporation, the section 1296(c) look-through rule would have a more limited application than intended. For example, in the case of a foreign corporation 10 percent of the stock of which is held by an upper tier foreign corporation and 90 percent of the stock of which is held by the upper tier foreign corporation's U.S. parent, the look-through rule would not apply unless constructive ownership rules were made applicable.

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[10] To apply constructive ownership for purpose of attributing income and assets would be administratively unwieldy, as almost all corporations in a group would be deemed to own almost all others in the group.

3. *Elimination of Stock and Debt*

A technical correction should provide that in attributing income and assets of 25 percent owned foreign corporations under the section 1296(c) look-through rule to an upper tier foreign corporation, the stock and debt, and dividend and interest income with respect thereto, held by one 25 percent owned foreign corporation in another 25 percent owned foreign corporation should be eliminated from the assets and income of the former corporation. Similarly, gain from the sale of the stock or obligation of a 25 percent owned foreign corporation should be eliminated. The look-through rule was enacted to prevent holding companies formed to own active operating subsidiaries from being treated as PFICs. This purpose cannot be fulfilled unless stock and debt, and the income with respect thereto, is eliminated throughout the corporate chain of 25 percent owned foreign corporations. Although this was the apparent intention of the provision,[11] the statute should explicitly provide for this result.

E. *Time for Determination of PFIC Status*

A technical correction should clarify that stock of a foreign corporation held by a taxpayer will be treated as stock of a PFIC only if such foreign corporation was a PFIC for one or more post-1986 taxable years. Based on a literal interpretation of sections 1297(b)(1) and 1296, neither of which incorporate the effective date of the PFIC provisions, it is not clear whether stock held by a taxpayer could be treated as PFIC stock where the foreign corporation met the definition of a PFIC under section 1296(a) only for pre-1987 taxable years.

III. *NONQUALIFIED FUNDS*

A. *Deferred Tax Amount May Be offset by Foreign Tax Credits*

A technical correction to section 1291(a)(1)(C) should clarify that the entirety of the deferred tax amount constitutes a tax which may be offset by foreign tax credits. As enacted, it is not clear whether the deferred tax amount increases absolutely the tax for the current year or may be offset by foreign tax credits, although the latter appears to have been the intention.[12] This lack of clarity is particularly pronounced with respect to the interest element of the deferred tax amount.

B. *Gain on Disposition*

1. *Gain Limited to Earnings and Profits*

A technical correction should provide that, in the case of a disposition of PFIC stock, section 1291 applies to gain recognized only to the extent of the taxpayer's ratable share of the earnings and profits of such corporation accumulated for the period the taxpayer held such stock. The interest charge on the deferred tax amount was intended to approximate the time value of deferral obtained through the foreign corporation, thus putting such corporations on an equal footing with domestic corporations. However, unlike the provisions governing taxation of domestic corporations, section 1291(a)(2), as enacted, potentially applies the interest charge to gain attributable to appreciation unrealized at the corporation level, such as appreciation attributable to goodwill and going concern value, as well as tangible assets, with respect to which the payment of U.S. tax has not been deferred. This technical problem may be corrected by limiting the amount of gain subject to section 1291 by reference to earnings and profits.

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[11] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1026 (Comm. Print 1987).

[12] *See* section 1291(a)(4). *See also* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1027 (Comm. Print 1987).

2. *Determination of Pro Rata Share*

In determining the amount of gain on a disposition of PFIC stock which is subject to section 1291, a technical correction should provide that a taxpayer's pro rata share of the earnings and profits of the PFIC excludes the taxpayer's pro rata share of any earnings and profits which are attributable to (i) amounts previously included in gross income of the taxpayer under sections 551, 951(a) and 1293(a) (but only to the extent the inclusion of such amount did not result in an exclusion of any other amount from gross income under section 551(d), 959(a), or 1293(c)),[13] (ii) income which is effectively connected with the conduct of a trade or business in the United States unless exempt from tax (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States, (iii) income subject to an effective rate of tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11, (iv) income of the PFIC other than passive income, and (v) income earned for taxable years of the PFIC beginning before January 1, 1987.

The PFIC provisions, which are effective for taxable years of foreign corporations beginning after December 31, 1986, were intended to remove the benefit of tax deferral and the ability to convert ordinary income to capital gain with respect to passive income earned through foreign corporations. Amounts included currently in gross income under section 551, 951(a) and 1293(c) and amounts effectively connected with a trade or business in the United States are not subject to deferral of tax and should not be subject to PFIC treatment. Where there would be little or no U.S. tax owed because of the foreign tax credit provisions of section 902 or 960, no interest element should apply. Gain attributable to active business operations also should not be subject to PFIC treatment since it is only the elimination of deferral on passive income which was within the stated intent of Congress. Similarly, gain attributable to pre-1987 tax years should not be subject to PFIC treatment.

C. *Total Excess Distribution*

1. *Incorporation of Dividend Concept*

A technical correction should limit the term "total excess distribution" to dividends paid out of earnings and profits. There is no precedent in either law or policy for subjecting to taxation a return of capital. Thus, taxation of such amounts cannot have been deferred.

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[13] The Bill includes a provision that would exclude such amounts from excess distributions. Technical Corrections Act of 1987, H.R. 2636, 99th Cong., 1st Sess. § 112(n)(3) (June 10, 1987).

2. *Exclusion from Earnings and Profits*

For the reasons discussed in B.2 above, a technical correction should exclude from total excess distributions any earnings and profits attributable to (i) amounts previously included in gross income under section 551, 951(a), or 1293(c), (but only to the extent the inclusion of such amount did not result in the exclusion of any other amount from gross income under section 551(d), 959(a), or 1293(c)),[14] (ii) income which is effectively connected with the conduct of a trade or business in the United States unless exempt from tax (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States, (iii) income subject to an effective rate of tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11, (iv) income of the PFIC other than passive income, and (v) income earned for taxable years of the PFIC beginning before January 1, 1987.

D. *Allocation of Excess Distribution*

The amount of an excess distribution (or gain on disposition subject to section 1291) should be allocated to the taxable year (or years) in the taxpayer's holding period during which the earnings and profits giving rise to such excess distribution (or gain subject to section 1291) were earned. In this manner, the excess distribution would be allocated to the periods in which the earnings and profits supporting the distribution were earned, thus providing a better measure of the economic value of deferral. This methodology also would ensure that amounts allocated to post-1986 years actually arose in such years. Under the statute as enacted, pre-1987 earnings and profits of a PFIC become increasingly allocated to post-1986 years in the taxpayers holding period as time passes, although Congress apparently intended that pre-1987 earnings should not be subject to an interest charge.

E. *Mark-to-Market Election*

A technical correction should make the mark-to-market election of sections 1291(d)(2) and 1297(b)(1) expressly applicable to stock held indirectly, and should provide for a basis increase up the corporate chain with respect to indirectly held stock deemed disposed of under the mark-to-market election. As enacted, it is unclear whether the election also applies to indirectly held PFIC stock such as second and third tier foreign subsidiaries of a directly held PFIC. The respective tax basis of each direct parent shareholder of a PFIC subsidiary with respect to which such deemed sale is made should be increased to prevent double taxation of such gain on a disposition by the direct foreign corporation shareholder.

IV. *QUALIFIED ELECTING FUNDS*

A. *Exclusion of Effectively Connected Income*

A technical correction should provide that earnings and profits attributable to income which is effectively connected with the conduct of a trade or business in the United States are not included currently in the income of U.S. person PFIC shareholders unless such income is exempt from tax (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. U.S. tax on such amounts cannot be deferred in any event. Inclusion of earnings and profits attributable to such amounts potentially results on a current basis in a triple

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[14] *See* note 13, *supra*.

U.S. tax, *i.e.*, corporate tax at graduated rates, branch profits tax, and shareholder level tax. In making this change, an ordering rule similar to that in section 959(c) would be needed so as to determine the extent to which subsequent distributions are made from previously taxed income.

B. *Investments in United States Property*

A technical correction to section 951(f) should provide that amounts which would be included under both sections 951(a)(1) and section 1293(a) will be included in income only under section 951(a)(1). As enacted, section 951(f) prevents double taxation of earnings and profits which constitute both subpart F income and earnings and profits of a qualified elected fund. However, the recommended correction is required to prevent a double inclusion of amounts which would be taxable as both an increase in earnings invested in the United States property and earnings and profits of a qualified electing fund.

V. *Rules for Allocation of Interest, etc., to Foreign Source Income*

A technical correction should provide that, for purposes of determining the basis of stock of a "nonaffiliated" 10 percent owned corporation under section 864(e), proper adjustments should be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under subpart F, the PFIC provisions or any other provision and reflected in the adjusted basis of *any property*. Although section 112(g)(1) of the Bill makes a similar correction, such provision can be interpreted to apply only to the extent earnings and profits currently included in the gross income of a U.S. person increase the basis of the stock of the foreign corporation with respect to which such current inclusion is made. However, such a result is too narrow to prevent double counting since current inclusions of the earnings and profits of lower tier foreign corporations under section 1293 increase the basis of the property on account of which the taxpayer is treated as owning the stock of the PFIC. Thus, current inclusions in income on account of a second tier foreign corporation increase the basis of the stock of the first tier foreign corporation which is held directly by the U.S. parent. §§ 1293(d)(1) & 961(a).

* * * * * *

We appreciate the opportunity to comment on the Bill. If you have any questions or comments, please contact me or Nancy H. Kaufman at (202) 862-2200.

Respectfully submitted,

Kenneth Klein

COMMENTS ON H.R. 2636
TECHNICAL CORRECTIONS BILL OF 1987

Prepared by Michael J. McIntyre
Professor of Law
Wayne State University Law School
July 10, 1987

1. **Inventory Property**. As I read § IRC 865, inventory property may include depreciable property, intangible property, and property producing currency transaction gains. It is possible that it includes property treated as ordinary income property under the Corn Products case. What is the intent of Congress? I would think that the bill should make clear the following points:

a. The source rules of IRC § 988(a)(3) (relating to foreign exchange gains and losses) take precedence over IRC §§ 865, 861, and 862. Are we expected to draw that inference from the cross reference?

b. Sales of stock and sales of intangibles never result in gains sourced under the passage-of-title test. That is, those types of property are never inventory property.

c. The depreciation recapture rule takes precedence over the rule applicable to inventory property (to deal with the case of depreciable property that is inventory property). Congress could handle the problem the way it handles a somewhat similar problem under IRC § 1231 by excluding property defined in 1221(2), (3), (4) and (5) from the definition of inventory property.

In the cases described above, application of the passage-of-title test would have no bearing on the amounts of U.S. exports. Protecting exports is the reason given for retention of that test for inventory property. (It would not be a mere technical correction, but I would not apply the passage-of-title test to the sale of depreciable property in any case.)

2. **Section 1248 Gains**. The following points may need clarification:

a. Where does the Code provide, as the cross reference in IRC § 865 suggests, that section 1248 gains have their source under the dividend source rules? Should there also be a cross reference in the dividend source rules?

b. What is left, after repeal of the capital gains rules, of Code section 1248, given the language of § 1248(g)(2)(B) (limiting the application of that section to income taxed as capital gains). Obviously that exception should not apply to prevent the application of IRC § 1248(f) (relating to realization of gain on certain tax-free transactions).

3. **Definition of Related Person**. I understand the reasons for changing the related person rule of subpart F to over 50 percent (rather than 50 percent or more). It would be very useful, however, to clarify the following points:

a. A buffer entity that is effectively controlled by related persons or serves as a conduit can be ignored for purposes of determining whether a sale is a sale to a related party. Alternatively, a buffer entity can be considered a related party. Consider, for example, P, a U.S. parent corporation and its foreign subsidiary, H, organized in a tax haven. B is a buffer entity organized and owned by a lawyer in the tax haven. P sells to B, and B sells to H. Do sales by H generate subpart F income? As I read the Code, the answer is no, unless B is a sham. Sham treatment can be avoided by giving the buffer some income and having it perform some services, such as arranging for import licenses, etc. The bill should provide that a buffer entity, even if it is not a sham, can be ignored in determining whether there has been a purchase or sale to a related party. The buffer problem in the base company sales rules is analogous to the back-to-back loan problem.

b. Reg. § 957-1(b) provides that a corporation will be a CFC if the U.S. shareholders have informal or contractual rights that give them effective control. The rule is usually applied to give CFC status to a corporation that is owned 50-50 by U.S. and foreign interests. Does this rule also apply in determining whether a corporation is a related person under Code section 954(c)(3)? The answer should be yes. Congress justified keeping the over-50 percent rule of IRC § 957 on the ground that abuse cases could be handled under Reg. § 957-1(b). If we are going back, as the draft bill provides, to an over-50 percent rule for the definition of a related party, we should apply the substance rule of Reg. § 1.957-1(b) to the definition of a related person. Harmony of the CFC definition and the related person definition is desirable according to the Staff's explanation of H.R. 2636 at pages 203-204.

4. **Source of Branch Bank Income**. Is it the intent of Congress that bank interest paid by a U.S. branch of a foreign corporation will be foreign source income even if that interest is received by a U.S. resident? I believe that result follows from the change in the interest source rules eliminating the reference to resident corporations in IRC § 861(a)(1) (old version "residents, corporate or otherwise"). I have no view on the correct answer, but I find the change curious, as I have not seen it discussed in the legislative history. Foreign branch interest of a U.S. corporation is foreign source income under IRC § 861(a)(1)(B)(i).

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July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel,
Committee on Ways and Means,
U.S. House of Representatives,
1102 Longworth House Office Building,
Washington, D.C. 20515.

Re: Proposed Amendments Related to Title XII of the Tax Reform Act of 1986 and Section 112 of the Technical Corrections Act of 1987

Dear Sir:

This letter and the attached memoranda are submitted for the record of written comments on H.R. 2636, the Technical Corrections Act of 1987 pursuant to Press Release #15 in which Chairman Rosenkowski announced the extention of the period for submitting written comments until Friday, July 17, 1987.

These memoranda were prepared at the direction of the Subcommittee on Taxation of International Operations of the Tax Policy Committee of the Securities Industry Association. The first memorandum suggests clarification of the treatment of Section 954(c)(1)(B) of the Internal Revenue Code of 1986, as amended (the "Code"). The second proposed amendment relates to Section 904(g) of the Code and Section 112(z)(4) of the Technical Corrections Act of 1987.

I appreciate your consideration of these matters.

Sincerely,

Randall K.C. Kau

Randall K.C. Kau

Hedging Transactions

Background

The extreme volatility of interest rates and currency rates during the last few years has made it practically impossible for United States firms to plan for and conduct business worldwide without making extensive use of hedging transactions to reduce the risk of interest rate, price, or currency fluctuations to which they would otherwise be subject. This is particularly true in the case of financial intermediaries, such as dealers in securities, where substantially all assets and liabilities are subject to such risks.

Problem

The Tax Reform Act of 1986 (the "Reform Act") adopted special rules for dealer activity conducted by controlled foreign subsidiaries without explicitly addressing the taxation of the hedging transactions that are an integral part of the trade or business of a dealer in securities. Section 954(c)(1)(B) of the Internal Revenue Code of 1986, as amended (the "Code") continues the exclusion under prior law for gain from the sale or exchange of (i) property described in Section 1221(1) of the Code (*i*.*e*. stock in trade, inventory or property held for sale to customers in the ordinary course of business) or (ii) any property held by a "regular dealer" in such property. Although the legislative history leaves no doubt that sales of securities by a dealer in securities are described in Section 954(c)(1)(B) of the Code,* it is unclear whether gain arising out of a hedge entered into in the normal course of activities by a dealer in securities are also covered. Section 954(c)(1)(C)(i) of the Code does provide for an exclusion for hedges entered into through futures, forwards, and similar transactions by a "producer, processor, merchant or handler of a commodity" but may not reach a securities dealer, since a "security" may not be a "commodity" for this purpose.**

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* S. Rep. 99-313, 99th Cong., 2nd Sess. at p. 367 (securities gains of regular dealers excluded) (May 29, 1986), Conference Report at p. II-644 (bona fide underwriters of securities excluded from classification as a passive foreign income corporation), and Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* at p. 974 (May 4, 1987) (hereinafter the "Blue Book") (securities gains of regular dealers excluded).

** *See*, however, PLR 8540033 (July 3, 1985) (cash settled futures contracts on S&P 500, NYSE Composite Index, Comex 500 Stock Index, and Eurodollar Time Deposits treated as "commodities" for purposes of Section 864(b)(2)(B) of the Code relating to trading in commodities by foreign corporations).

Recommendation

In order to deal with the foregoing problem, we recommend the adoption of a technical amendment to Section 954(c)(1)(B) of the Code, by deleting the period and adding at the end of the last sentence the following:

> ", including hedging transactions described in Section 1256(e)."

Comment: The failure to provide a specific hedging exclusion for a securities dealer appears to be an oversight, since a securities dealer cannot be distinguished from other dealers that engage in hedging transactions. Just as a wool merchant may hedge his position in wool inventory or a manufacturer of corn syrup and other corn products may hedge his raw material supply with futures contracts on corn, so also will a dealer in securities hedge his inventory of debt securities and other ordinary income activity. For example, a controlled foreign subsidiary engaged in the business of underwriting and selling Eurobonds would normally protect its position by entering into short futures contracts on various interest rate indices. In this fashion any loss on long inventory positions arising as a result of an increase in interest rates would be offset by gains on the futures contracts.

The appropriateness of providing for a specific exclusion for gains from hedging transactions seems evident from the exclusion in Section 954(c)(1)(D) of the Code for gains from foreign currency positions entered into to hedge the impact of foreign currency fluctuations on positions in foreign currency denominated debt securities and other ordinary income generating activities of a dealer. See Blue Book at p. 976. There is no reason hedges of U.S. dollar interest rate risks should be treated more harshly than hedges of foreign currency or other price risks. Cf. Section 1256(e)(2)(A) of the Code (hedging transactions include transactions entered into primarily to reduce the risk of price change, currency fluctuations, or interest rate changes).*

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* LTR 8623003 (February 11, 1986); LTR 8435054 (May 24, 1984).

Double Taxation of Interest Received by U.S. Broker-Dealers on Inventories of U.S. Securities Held in Foreign Countries

Background

In general, U.S. firms have conducted the business of being dealers in securities in foreign countries through controlled foreign corporations ("CFCs") rather than branches because of the need to comply with the requirements of various jurisdictions -- principally the United States, the United Kingdom, Japan, and Switzerland. See, generally Department of the Treasury, National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations (December 18, 1986). Each of these countries taxes firms conducting a securities business at ordinary income rates currently ranging from 35% in the United Kingdom to 57% in Japan on the income derived within the taxing jurisdiction. This will include, among other items, interest, dividends, and net gain on securities held for sale to customers in the ordinary course of the trade or business.

The Tax Reform Act of 1984 and the Tax Reform Act of 1986 (the "Reform Act") included a number of provisions which have had a profound impact on the issuance and distribution of securities by U.S. borrowers, including the United States Treasury. In particular, the repeal of the 30% withholding tax on portfolio interest and the promulgation by the Treasury and Internal Revenue Service of implementing regulations has resulted in U.S. borrowers obtaining direct access to international capital markets. Net purchases by foreigners of U.S. corporate bonds increased from $903 million in 1983 to $43.5 billion in 1986. Net foreign purchases of U.S. Treasury notes and bonds rose from $3.7 billion in 1983 to $24.3 billion in 1986.

Problem

The interest income which accrues on bonds of U.S. issuers while held in inventory of a dealer in securities is treated as U.S. source income under generally applicable rules. Section 861(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). Where the dealer is a U.S. owned foreign corporation, interest, dividends, and Subpart F amounts derived by a U.S. shareholder from its U.S. owned corporation must be treated as U.S. source income to the extent provided by Section 904(g) of the Code, notwithstanding the fact that a foreign country may have imposed tax on such income. Thus if the U.S. shareholder is subject to an effective foreign tax credit limitation by reason of not having sufficient foreign source taxable income, it will be subject to double taxation.

U.S. shareholders of controlled foreign broker-dealers cannot avoid this double taxation of U.S. source interest on their inventories of debt securities. Section 881(c)(4)(A) of the Code overrides all the exclusions from Subpart F in the case of portfolio interest received by a CFC, including the exclusion in Section 954(b)(4) of the Code for items of income subject to an effective rate of foreign income tax greater than 90% of the maximum U.S. statutory rate. This double taxation places U.S. controlled broker dealers at a severe competitive disadvantage vis-a-vis foreign-owned broker-dealers.

Recommendation

To deal with the foregoing problem, the Subcommittee on Taxation of International Operations (the "Subcommittee") of the Tax Policy Committee of Securities Industry Association makes the following two recommendations:

1. Section 881(c)(4)(A)(ii) of the Code should be deleted.

Comment: This amendment is appropriate because Section 954(b) and (c) of the Code relating to the exclusions from Subpart F were substantially amended by the Reform Act. Deletion of the reference in Section 881(c)(4)(A)(ii) to Section 954(b)(4) of the Code would result in an exclusion from Subpart F for CFCs receiving portfolio interest only if such income is subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax imposed on domestic corporations. Because the Reform Act eliminated the subjective test of prior law, the objective test now in the Code provides assurance that the exclusion will not be availed of in countries which are "tax havens."

2. Section 112(z)(4) of H.R. 2636, the Technical Corrections Act of 1987, as introduced on June 10, 1987, should be amended by striking lines 5 through 21 on page 376 and inserting in lieu thereof:

"(10) EXCEPTION FOR INCOME SUBJECT TO FOREIGN INCOME TAX. -- If --

(A) any amount derived from a United States-owned foreign corporation would be treated as

> derived from sources within the United States under this subsection by reason of an item of income of such United States-owned foreign corporation, and
>
> (B) such item of income bears an effective rate of income tax of at least 10 percent,
>
> this subsection shall not apply to such amount to the extent attributable to such item of income."

Comment: Section 112(z)(4) of the Technical Corrections Act of 1987 would amend Section 904(g) of the Code by overriding the re-sourcing rule where a treaty obligation of the United States otherwise provides. Any income, however, would be subject to a separate limitation to the extent attributable to an item of U.S. source income earned by the foreign corporation.

Although the technical amendment is a step in the direction of ameliorating a serious double taxation problem, it relies in the first instance on provisions of a tax treaty governing source. In many instances, the treaties, particularly older treates, are silent or ambiguous as to source. In the case of modern treaties, including those with major countries in which financial centers are located (Australia, Canada, Japan, the United Kingdom, and Switzerland), the availability of treaty protection against double taxation by reason of conflicting source rules is ambiguous at best.

The Subcommittee respectfully submits that the double taxation of a U.S. taxpayer can occur whether or not there is a tax treaty. Accordingly, the principle which Section 112(z)(4) of the Technical Corrections Act should incorporate is that Section 904(g) will not apply to any amounts derived from a foreign corporation where the country in which the foreign corporation is resident exercises the primary right under international law and custom as the country of residence to tax its residents and subjects such income to a rate of tax of at least 10%. This concept is similar to that now included in Section 865(e)(1)(B) of the Code (relating to the source of income derived by a United States resident on sales of certain personal property attributable to an office or other fixed place of business outside the United States) and Section 865(g)(2) of the Code (relating to the definition of a United States citizen or resident alien for purposes of determining the source of any sale of personal property). In each of these situations, the source of income is treated as foreign notwithstanding conflicting rules and regardless of the presence or absence of a tax treaty if the taxpayer is subject to an actual rate of income tax of at least 10%.

Source of Income Under Income Tax Treaties

United Kingdom

Article 23(3) of the Treaty with the United Kingdom provides as follows:

> "For purposes of the preceding paragraphs of this Article, income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within that other Contracting state, except that where the United States taxes on the basis of citizenship, the United Kingdom shall not be bound to give credit to a United States national who is a resident in the United Kingdom on income from source outside the United States as determined under the laws of the United Kingdom and the United States shall not be bound to give credit for United Kingdom tax on income received by such national from sources outside the United Kingdom as determined under the laws of the United States."

This provision may not apply to prevent Section 904(g) of the Internal Revenue Code of 1986, as amended (the "Code") from recharacterizing interest, dividend, or Subpart F amounts derived from a United States owned foreign corporation which is a United Kingdom resident corporation for the following reasons:

1. Article 23(1) which is referred to by the opening clause of Article 23(3) only requires the United States to allow its residents or nationals a credit against United States tax for United Kingdom tax "[I]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

2. Interest paid by United States owned foreign corporation resident in the United Kingdom to a United States shareholder is exempt from taxation by the United Kingdom under Article 11(2) of the Treaty, and Article 23(3) by its own terms would not apply.

3. Section 904(g) of the Code applies to Subpart F amounts. It is unclear whether Subpart F income includible in a United States resident's gross income is income "which may be taxed in the other Contracting State" within the meaning of Article 23(3) of the Treaty.

Japan

Article 5(1)(a) of the Income Tax Treaty with Japan provides as follows:

> "In accordance with the provisions of the law of the United States, as in force from time to time, regarding the allowance of a credit against United States tax of tax payable in any country other than the United States, the United States shall allow to a citizen or resident of the United States as a credit against United States tax the appropriate amount of Japanese tax and, in the case of a United States corporation owning at least 10 percent of the voting power of a Japanese corporation from which it receives dividends, shall allow credit for the appropriate amount of Japanese tax paid by the Japanese corporation paying such dividends with respect to the profits out of which such dividends are paid. For the purpose of applying the United States credit in relation to taxes paid to Japan, the rules set forth in Article 6 shall be applied to determine the source of income."

This provision may not apply to prevent Section 904(g) of the Code for the following reasons:

1. Article 5(1)(a) appears to incorporate the provisions of the law of the United States, as in force from time to time, and it could therefore be read to be overridden by Section 904(g) of the Code under the general principle that the provision of law enacted later in time governs.

2. Article 6(1) of the Treaty treats dividends as income from sources within a Contracting State if paid by a corporation of that Contracting State, and Article 6(2) treats interest as income from sources within a Contracting State if paid by, among other entities, a resident of that Contracting State in most circumstances. Assuming the ambiguities in Article 5(1)(a) discussed in paragraph 1 above were resolved in favor of a taxpayer, these provisions would appear to override Section 904(g) of the Code. Subpart F inclusions, however, are not addressed by the Treaty, and Article 6(9) states that the source of items of income not described in paragraphs (1) through (8) of Article 6 are determined by each of the Contracting States in accordance with its own law.

Switzerland

Article XV(1)(a) of the Treaty with Switzerland requires the United States, subject to the provisions of Section 131 of the Internal Revenue Code of 1939, as in effect on the date of entry into force of the Treaty, to deduct from its taxes the amount of Swiss taxes specified in Article I. This provision, however, may have no relevance to the source of income derived by any United States shareholder.

Canada

Article XXIV(3)(a) of the Treaty with Canada, which was brought into force on August 16, 1984, almost contemporaneously with the Tax Reform Act of 1984, provides:

> "Profits, income, or gains [other than gains recognized by individual residents] of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules) shall be deemed to arise in the other Contracting State."

It is not clear whether this provision would include Subpart F amounts which are derived by a controlled foreign subsidiary which is a Canadian resident although it arguably would apply to interest paid by a Canadian subsidiary to its United States parent because Article XI permits Canada to tax such interest at a rate not to exceed 15% of the gross amount. Similarly, dividends paid by a Canadian subsidiary to a United States shareholder are arguably treated as derived from Canadian sources regardless of the underlying income derived by the Canadian subsidiary because Article X permits Canada to tax such dividends at a rate not to exceed 15% (10% where the beneficial owner is a corporation owning at least 10% of the voting stock of the company paying the dividends).

Australia

Article 22 of the Treaty with Australia states that no provision of the Treaty relating to source of income shall apply in determining credits against United States tax for foreign taxes other than Australian taxes. There appear, however, to be no provisions which explicitly deal with source of income.

Section 1201

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July 29, 1987

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Rostenkowski:

I am writing you to urge your support for a legislative proposal which will be offered to amend the Tax Reform Act of 1986 foreign tax credit provisions. This change is being sought by the U.S. Chamber of Commerce, the National Association of Manufacturers, the National Foreign Trade Council, and the Bankers' Association for Foreign Trade. As a company actively involved in exporting U.S. goods and services, I join these groups in requesting this change which will benefit U.S. exports and trade competitiveness.

Under the new tax law, the foreign tax credit rules have imposed a roadblock to U.S. companies of all sizes which need financing for their exports. The problem with the law is that it narrowly limits the use of tax credits formerly allowed to U.S. banks for the payment of foreign taxes on trade finance income. The result is that affordable trade financing is no longer available to most U.S. companies.

As you know, Congress has recently been actively reviewing comprehensive trade legislation. However, it has failed to remedy the export financing problem created by last year's tax act. Therefore, I urge you to support an amendment which will restore favorable tax treatment for export financing income and will encourage U.S. exports, competitiveness and the creation of jobs in America. I am hopeful that the opportunity to obtain this important change may present itself during consideration of legislation now pending before the Congress.

As a tax writing committee member, you are in a key position to advance the cause of U.S. competitiveness by supporting this amendment. Trade finance is a vital element of U.S. competitiveness and this amendment will go far in improving our trade prospects.

Sincerely,

R. C. Frey

American Express Company
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AMERICAN EXPRESS

July 16, 1987

Robert Leonard, Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Bob
Dear Mr. Leonard:

In response to your request for comments on the Technical Corrections Act of 1987, I am enclosing for the Committee's consideration a draft of a proposed technical amendment to Section 1201 (e) of the Tax Reform Act of 1986. This amendment addresses a problem that we have identified in the current high withholding tax transition rule that discourages debt-to-equity conversions of existing LDC loans.

From a Federal tax perspective, U.S. banks now find themselves in a difficult position in electing between a debt-equity conversion and full foreign tax credit utilization. Specifically, if a U.S. bank does nothing, interest on its existing debt has the benefit of the 1986 Act's transitional relief provision for high withholding tax interest. This specifies that interest on loans to 33 listed countries is includable in the financial service basket for 3 years and then phased out over the next five years.

A conversion of a qualifying loan from debt into an equity investment, however, results in the loss of this beneficial transitional rule and subjects the resulting income to the new separate baskets limitation rules. Upon conversion, a bank would be required to determine, on an investment-by-investment basis, which foreign tax credit basket to account for these equity investments. Under most circumstances, it will be difficult to qualify income from loan conversions as financial services income since the underlying income of the new equity investment will generally not be either passive income or income derived in the active conduct of a banking, financing, or similar business. Moreover, with most such equity conversions resulting in an interest in the investee company of between 10% and 50% with local entities holding the balance, the non-controlled Section 902 corporation basket is likely to apply.

Total local income taxes, plus withholding taxes on distributions, will usually cause the effective foreign tax rate on these investments to exceed significantly the U.S. tax rate. Therefore, the loss of transitional relief and the ability to average these excess credits with other financial services income, coupled with the harsh effect of the joint venture rules, can make debt-equity conversions unprofitable on an after-tax basis.

To cure this problem and to promote debt-equity conversions, it is recommended that a technical amendment be adopted to clarify that income received following a debt-equity conversion be situated in the same foreign tax credit category as the interest from the debt that was converted. (The proposed statutory language and a more detailed technical explanation are enclosed.) In recognition of revenue constraints, we have attempted to parallel the seven-year period of application for the high withholding tax

interest transition rule and we propose that a taxpayer's principal amount of qualified loans entitled to transitional relief be reduced by the amount of any such loan conversion.

We strongly believe that the Federal tax laws should not inhibit debt-to-equity conversions. Such conversions are especially attractive for lesser developed countries as they provide one of the most viable means by which to reduce their indebtedness to U.S. lenders. Secondly, loan workouts, by means of conversions, historically have permitted lenders to recover on their original loan principal and, until payback is achieved, to secure an adequate rate of return. In fact, the Pre-1986 TRA Section 954-2(d) regulations expressly recognized this well-established banking practice.

We look forward to working with the Committee on this matter. American Express Bank Limited has been at the forefront of such conversions and has the technical staff available to respond to your inquiries.

Sincerely,

Denise G. Ferguson

Denise G. Ferguson

Enclosure(s)

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AMERICAN EXPRESS

June 29, 1987

The Honorable Roger Mentz
Assistant Secretary for Tax Policy
Department of the Treasury, Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Roger:

I am enclosing for your consideration a draft of a proposed technical amendment, and explanation thereof, for addressing the anomaly in the current high withholding tax transition rule that discourages debt-equity conversions of existing LDC loans. This proposal reflects many of the concerns raised at our May 27 meeting.

The assistance of the Department in developing a revenue estimate for this proposal would be most helpful. It is hoped that this problem can be resolved in the pending Technical Corrections legislation.

Should you have any questions, please do not hesitate to contact either me or David Rosenbloom of Caplin and Drysdale. We look forward to working with you on this matter.

Sincerely,

Denise G. Ferguson

DGF:crm

Enclosure(s)

Amendments to Section 1201(e) of the Tax Reform Act of 1986

I. Sec. (2)(F) is amended by the addition of a new paragraph (iii):

(iii) The principal amount of qualified loans held by the taxpayer on November 16, 1985 shall be reduced by the principal amount of such loans which are the subject of a "debt-equity conversion."

II. Sec. (2) is further amended by the addition of a new paragraph (J):

(J) For purposes of this subsection the term "debt-equity conversion" means a transaction, pursuant to foreign law, whereby one or more qualified loans held by the taxpayer or an affiliate on November 16, 1985 are exchanged for, or otherwise converted into, stock in a foreign corporation. In the case of a debt-equity conversion involving debt not exceeding 110 percent of a qualified loan or loans so converted, dividends with respect to such stock and gains from the sale or exchange of such stock shall be treated for purposes of section 904 as interest, but not as high withholding tax interest. The preceding sentence shall cease to apply after the end of the sixth taxable year of the taxpayer following the year in which dividends are first paid by the foreign corporation and includible in the gross income of the taxpayer or an affiliate after the debt-equity conversion.

EXPLANATION OF AMENDMENTS TO SECTION 1201(e) OF THE TAX REFORM ACT OF 1986

The proposed amendments are intended to encourage the conversion of certain developing country loans into stock interests in corporations doing business in those countries. Interest on such loans is, in general, subject to a foreign withholding tax. However, such interest is not (for a specified period and to a specified extent) high withholding tax interest by reason of transition rules that were adopted in section 1201(e) of the Tax Reform Act.

Conversion of such loans into stock is, under present law, disadvantageous because dividends and gains from the sale of stock do not qualify for the high withholding tax transition rules. Thus, as matters stand today, the rules regulating the foreign tax credit limitation actually discourage debt-equity conversions.

The proposed statutory amendments are intended to remedy that situation. As a technical matter, they are cast as amendments to the transition rules for high withholding tax interest and are intended to parallel those rules.

The first amendment provides that any qualified loan held by the taxpayer on November 15, 1985 which is the subject of a debt-equity conversion will reduce the "principal amount of qualified loans held by the taxpayer on November 16, 1985." This amount is a crucial component of the "applicable credit limit" used to compute high withholding tax interest transition relief. The amendment will prevent taxpayers from achieving a double benefit -- one in the special rule for debt-equity conversions (discussed below), and another in transition relief for the amount of the debt that is thus converted.

The second amendment is a special rule for income resulting from a debt-equity conversion. As noted above, this income will be in the form of dividends from stock and gains from the sale or exchange of stock. The special rule provides that such dividends and gains will be treated for purposes of the foreign tax credit limitation as interest, but not as high withholding tax interest. The rule will have the effect of situating income received following a debt-equity conversion in the same foreign tax credit category as interest from the debt that was converted.

Dividends and gains following a debt-equity conversion will be interest, under the special rule, only for purposes of the foreign tax credit limitation. Thus, dividends with respect to stock received as a result of a debt-equity conversion, and gains from the sale or exchange of such stock, will be eligible for the deemed paid foreign tax credit under section 902, 960, or 1248. However, for purposes of section 904, all such income will be treated as interest.

For taxpayers who are predominantly engaged in a banking, financing, or similar business, such interest will be financial services income. For other taxpayers, the interest will be passive income.

The special rule for debt-equity conversions will apply regardless of whether the stock interest in the foreign corporation is a majority interest and regardless of whether the entity that holds the stock interest is the original lender or an affiliate. That is, the benefits of the rule will not be affected by the section 904 rules relating to noncontrolled section 902 corporations and to the "look-through" rules applicable to controlled foreign corporations. It is expected that debt-equity conversions will generally result in minority stock interests, over time if not initially. Furthermore, it is anticipated that, in certain cases, the foreign tax cost of a stock investment can be reduced by holding the interest in a foreign corporation.

The benefits of the rule will be geared roughly to the seven-year period of application of the high withholding tax interest transition rules. However, in light of the fact that a taxpayer's return following a debt-equity conversion may require a lengthy payout period, the seven-year transition period is proposed to begin only as of the first year in which the investment begins to pay dividends to the taxpayer or an affiliate after the conversion.

Finally, the special rule for debt-equity conversions applies not only to loans held on November 16, 1985 but to an amount of up to 10 percent of other loans as well. The purpose of the rule is to encourage conversions, and a narrow limitation to debt held on November 16, 1985 could unnecessarily frustrate that purpose.

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July 16, 1987

BY HAND

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill (H.R. 2636)
Section 112(a)(1)(A) (Foreign Tax Credit)

Dear Mr. Leonard:

On behalf of International Business Machines Corporation ("IBM"), I am writing to urge the Committee to adopt a technical correction clarifying the application of the separate foreign tax credit limitations for financial services and passive income to income earned by foreign subsidiaries that lease a local affiliate's manufactured product.

In some cases, to comply with foreign regulatory restrictions, a foreign operating affiliate of a U.S. company must set up a local leasing subsidiary to lease the operating affiliate's products to local customers. Absent clarifying legislation, income earned by the leasing subsidiary inappropriately could be thought to fall within the purview of "financial services" or "passive" income, with the result that the credit for foreign taxes paid on that income would be subject to a separate limitation under Section 904(d).

The leasing income would not be subject to a separate foreign tax credit limitation if the operating affiliate had engaged in the leasing activities directly. Because the operating company would not be "predominantly engaged" in financial services activities, its income would not be within to the separate financial services basket. Section 904(d)(2)(C) (as amended by the Section 112(a)(1)(A) of the Technical Corrections Bill). Similarly, because the leasing activities would be an adjunct of the operating affiliate's manufacturing or marketing efforts, the income would be "active rental" income, and hence would be excluded from the definition of passive income. Section 904(d)(2)(A)(i), referencing Section 954(c)(2)(A).

This result should obtain similarly where the foreign operating company is required by local law to place its leasing operations in a local subsidiary. In the domestic context, the Conference Report recognizes that it may be appropriate to apply the "active rental income" rules on a consolidated group basis. Conf. Rep. 99-841, 99th Cong., 2nd Sess. II-566 (1986). The Technical Corrections Bill should contain a similar clarification that this rule (as well as the "predominantly engaged" rule) may be applied on a group basis in the case of a foreign affiliate and its local leasing subsidiary. Proposed bill language to this effect is attached.

Thank you for your attention to this matter.

Sincerely,

Andrew H. Friedman

Andrew H. Friedman

PROPOSED TECHNICAL CORRECTION

Section 904(d)(2) of the Internal Revenue Code of 1986 is amended by adding at the end thereof the following new subparagraph:

> "(J) LEASING ACTIVITIES. -- Whether income received by a corporation that engages primarily in leasing activities is passive income or financial services income shall be determined as if the recipient and its affiliated corporations (within the meaning of Section 1504(a) without reference to the limitation of Section 1504(b)(3)) that are organized under the laws of the same country as the recipient were a single taxpayer."

ROBERT T. MATSUI
THIRD DISTRICT, CALIFORNIA

COMMITTEE ON
WAYS AND MEANS

Congress of the United States
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July 6, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is in response to your request for suggestions for additional technical corrections. Specifically, I would like to propose a technical correction to the provision governing the carryforward of pre - 1987 overall limitation excess foreign tax credits against post - 1986 overall limitation foreign source income. This provision, when applied to banks, has completely unintended results.

As drafted, the statue diverts such carryforwards into the post - 1986 overall limitation "basket" to the extent they are treated as attributable to high withholding tax interest. This, in effect, prevents the utilization of pre-effective date excess foreign tax credits and is, therefore, inconsistent with our intent to permit taxpayers predominantly engaged in a banking, financing or similar business to carryforward excess pre - 1987 credits without penalty.

I have attached a memorandum which provides a more detailed analysis of the issue, a chart illustrating the problem, and a draft technical correction.

Sincerely,

Bob

ROBERT T. MATSUI
Member of Congress

STATEMENT OF PROBLEM

Under the 1986 Act, foreign tax credits from pre-1987 taxable years may be carried forward into post-1986 years and generally used against similar limitation income in post-1986 years. Where there is no similar limitation in the post-1986 years, the credit is carried forward against the overall limitation. A technical reading of the statute creates a problem for banks because pre-1987 foreign tax credits are carried forward against post-1986 financial services income and the term "financial services income" excludes high withholding interest income. Thus, a strict reading of the statutory language appears to require that pre-1987 foreign tax credits, to the extent attributable to gross withholding taxes of 5 percent or more, be carried forward against post-1986 overall limitation income--a category that generally includes no foreign income of banks.

Although this interpretation of the statute seems compelled by the literal language of the statute, it does not reflect the intention of the Congress as reflected in the Joint Explanatory Statement of the Managers accompanying the Conference Report.

Adherence to the strict interpretation would effectively deny the foreign tax credit, on a retroactive basis, with respect to a substantial portion, if not practically all, of the foreign taxes paid on cross border loans made before the enactment of the 1986 Act. It would also create an anomalous treatment for taxes on qualified loans to the 33 countries covered by the grandfather provision, allowing credit for taxes paid after 1986 (before the phase out of the grandfather rules), but effectively denying credit for taxes paid on those loans before 1987.

REASONS FOR CHANGE

(1) The carryforward of pre-1987 foreign withholding taxes paid by banks against the post-1986 overall limitation (rather than the financial services income limitation) is contrary to the intent of the Congress.

The effective prohibition on the utilization of pre-effective date excess foreign tax credits is inconsistent with the legislative history and the Conference Committee's intent that taxpayers predominantly engaged in a banking, financing or similar business should be permitted to carryforward such credits without penalty.

Under the House bill, it was intended that "foreign tax credit carryovers allowed for foreign taxes paid in pre-effective date taxable years reduce the U.S. tax in post-effective date taxable years only on income of the same limitation type as the income on which the carryover taxes were imposed. For example, foreign tax credit carryovers to a post-effective date taxable year that are allowed for foreign taxes paid in pre-effective date taxable years on income of a type subject to the new separate limitation for banking and insurance income are only to reduce the U.S. tax on banking and insurance income." Report of the Committee on Ways and Means on H.R. 3838 dated December 7, 1985. The proposal introduced a separate limitation basket for "banking and insurance income". Although a separate limitation "basket" was not created for foreign withholding taxes imposed on interest income, the creditability of such withholding taxes was based on a loan by loan limitation. The provision relating to withholding taxes was only applicable to foreign taxes paid or accrued after the effective date of the bill. Application of the House bill's rules to pre-effective date interest income subject to withholding taxes would treat such income as "banking and insurance income". Consequently, any pre-effective date withholding taxes which carried over to post-effective date years would be able to offset the U.S. tax on "banking and insurance income".

Under the Senate amendment, "foreign tax credit carryovers allowed for foreign taxes paid in pre-effective date taxable years reduce the U.S. tax in post-effective date taxable years on income of the same limitation type as the income on which the carryover credits were imposed. For example, foreign tax credit carryovers to a post-effective date taxable year that are allowed for foreign taxes paid in pre-effective date taxable years on portfolio dividends then subject to the overall limitation are only to reduce the U.S. tax on overall limitation income (as defined after the effective date)." Report of the Committee on Finance to Accompany H.R. 3838 dated May 29, 1986. The above statement indicates that taxes on income in the old law overall income basket will offset U.S. tax on income in the new law overall basket even though such income would otherwise be included in a new basket established under the bill. The Senate amendment did not create a separate limitation with respect to banking or financial services income. Since the income on which withholding taxes were imposed would have been in the overall income basket in pre-effective date periods, excess foreign withholding taxes paid in pre-effective date periods would be carried forward to offset U.S. tax on the bank's income in the post-effective date overall basket.

The conference agreement adopted the transitional rule contained in the Senate amendment for foreign tax credit carryforwards, with one modification. For financial institutions, "under the agreement, pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income..." (Conference Report II-585). The conference agreement specifically rejected the House proposal which would require application of new law sourcing of income for purposes of determining the proper carryforward basket. The intent was to permit all pre-effective date excess credits on old-law overall limitation income to offset U.S. tax on post-effective date financial services income (the financial services income basket for taxpayers predominantly engaged in the banking, financing or similar business is comparable to the "overall" basket for other taxpayers).

(2) The treatment of such carryforwards by banks is inconsistent with the treatment of such taxes for banks (and other taxpayers) incurred after 1986 with respect to existing loans to designated countries.

It is illogical to deny utilization of foreign tax credit carryforwards attributable to foreign withholding taxes paid by banks before 1987. For taxpayers having overall limitation income in post-1986 years, excess foreign withholding taxes incurred in pre-1987 years may be carried forward and utilized after 1986. Most banks will have no overall limitation income in post-1986 years and will be unable to utilize excess pre-1987 foreign withholding taxes which carry forward to post-1986 years.

The 1986 Act provides transitional relief for certain foreign withholding taxes paid after 1986. The transition rules permit all taxpayers, including banks, to claim current credits, to carry back excess taxes to pre-1987 taxable years, and to carry forward excess taxes to future years.

(3) The treatment of such carryforwards by banks unfairly discriminates against banks.

The provision which permits pre-effective date excess credits for taxes on old-law overall limitation income to be carried forward to offset tax subject to the new-law overall limitation income discriminates against taxpayers predominantly engaged in a banking, financing, or similar business. For most taxpayers predominantly engaged in the banking business, a large portion of the foreign taxes paid or accrued are withholding taxes. Application of the Act's rules requires pre-effective date excess withholding taxes to offset U.S. tax on post-effective date overall limitation basket income and at the same time sources virtually all of a bank's post-effective date income to the financial services or the high withholding tax interest baskets. A taxpayer who is not predominantly engaged in the banking, financing or similar business and who made a pre-effective date loan which generated excess withhholding taxes will carryforward those taxes to offset income in the taxpayer's new-law overall limitation basket. This treatment afforded such taxpayers is preferential to that given to financial institutions.

TECHNICAL DISCUSSION

The Act added several new income baskets for which the provisions of section 904 of the Internal Revenue Code of 1986 ("Code") must be separately applied. Two of the new baskets are "high withholding tax interest" and "financial services income".

The term "high withholding tax interest" means any interest if-

(I) such interest is subject to withholding tax of a foreign country or possession of the United States (or other tax determined on a gross basis), and

(II) the rate of such tax applicable to such interest is at least 5 percent. (Section 904 (d)(2)(B))

"Financial services income" is defined to include "income received or accrued by any person which is not passive income...and which -

(I) is derived in the active conduct of a banking, financing, or similar business,...(Section 904(d)(2)(C)(i)).

If for any taxable year, an entity is predominantly engaged in the active conduct of a banking, financing, or similar business, the term "financial services income" includes any passive income... of such corporation for such taxable year....(Section 904 (d)(2)(C)(ii) of the Code). The term "financial services income" does not include any high withholding tax interest. (Section 904 (d)(2)(C)(iv)).

In general, the changes made by the Act requiring separate foreign tax credit limitations to be computed for financial services income and for high withholding tax interest apply to taxable years beginning after December 31, 1986. (Act Section 1201 (e)(1)).

Section 904(c) of the Code permits the carryback and carryforward of foreign taxes paid or accrued to the extent such taxes exceed the limitation imposed by subsection 904(a).

Such excess taxes are deemed to be paid or accrued in the applicable period to which they are carried forward or carried back. The Act provides transitional rules to deal with the impact of the new separate limitation baskets on the carryforward of foreign taxes paid or accrued from pre-effective date taxable years.

In general, taxes paid or accrued in a taxable year beginning before January 1, 1986 (the 1986 date is presumably a misprint which should be changed to 1987 by technical correction) with respect to income which was included in the old-law 904(d)(1)(E) overall basket shall be treated as taxes paid or accrued with respect to income described in the new-law 904(d)(1)(I) overall basket. An exception in the case of a taxpayer which is predominantly engaged in the active conduct of a banking, financing or similar business, if the taxpayer establishes that such carryforward taxes were paid or accrued with respect to financial services income. (Section 904(d)(2)(I)(ii)). Although the transitional rule fails to specify the treatment for taxpayers which satisfy this financial services exception, the Internal Revenue Service in Advance Notice 87-6 has taken the position that such foreign taxes can be carried to post-effective date taxable years to reduce the U.S. tax on post-effective date financial services income.

The first step in analyzing whether a taxpayer predominantly engaged in the banking, financing, or similar business is permitted to carryforward taxes paid or accrued in years prior to 1987 to offset financial services income in 1987 and subsequent years is to determine if such carryforward taxes were paid or accrued with respect to financial services income. In making this determination, the taxpayer is to apply the new-law definition for financial services income. As indicated previously, financial services income specifically excludes high withholding tax interest.

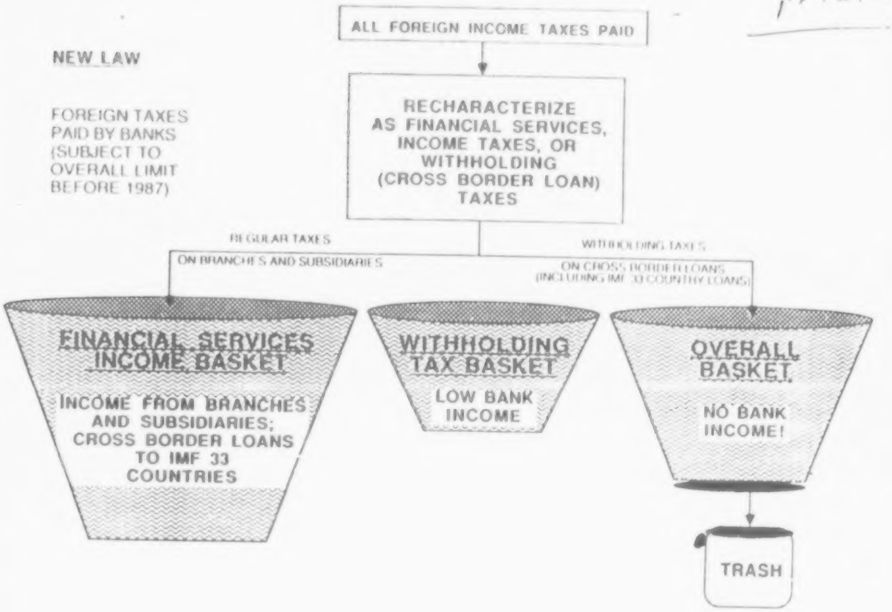
To mitigate some of the hardship created by the high withholding tax interest basket, the Act provides transitional relief by excluding from high withholding tax interest any interest received or accrued by a taxpayer during any taxable year beginning after December 31, 1986, and before January 1, 1990, on certain qualified loans to borrowers in 33 IMF countries. Since the exclusions from high withholding tax interest only apply to certain interest received or accrued after January 1, 1987, taxes paid or accrued on interest received or accrued prior to December 31, 1986, which otherwise satisfy the Section 904(d)(2)(B) test for high withholding tax interest, will be considered as paid or accrued with respect to high withholding tax interest.

Having determined that such paid or accrued taxes are considered to have been paid or accrued with respect to high withholding tax interest, it is important to examine how taxes paid with respect to pre-effective date high withholding tax interest are to be carried forward to 1987 and subsequent years. Under the law in effect in 1986 and prior years, interest income earned by a taxpayer engaged in the banking, financing or similar business which under new law definitions would be considered high withholding tax interest would have been included in the old law 904(d)(1)(E) overall basket. Pursuant to new Section 904(d)(2)(I), taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income described in the old law 904(d)(1)(E) overall basket will be treated as taxes paid or accrued with respect to income in the new law 904(d)(1)(I) overall basket unless such taxes were paid with respect to financial services income. Since the taxes were paid or accrued with respect to high withholding tax interest and financial services income specifically excludes high withholding tax interest, the general rule of Section 904 (d)(2)(I) will apply. Consequently, taxes paid with respect to such pre-effective date high withholding tax interest will be carried forward and be treated as taxes paid or accrued with respect to income in the new 904(d)(1)(I) overall basket. Since virtually all of the income of a taxpayer engaged predominantly in the banking, financing or similar business will be treated as financial services income or high withholding tax interest under the new law, the taxpayer will have no income which would fall within the new 904(d)(1)(I) overall basket and such carryover credits will never be utilized.

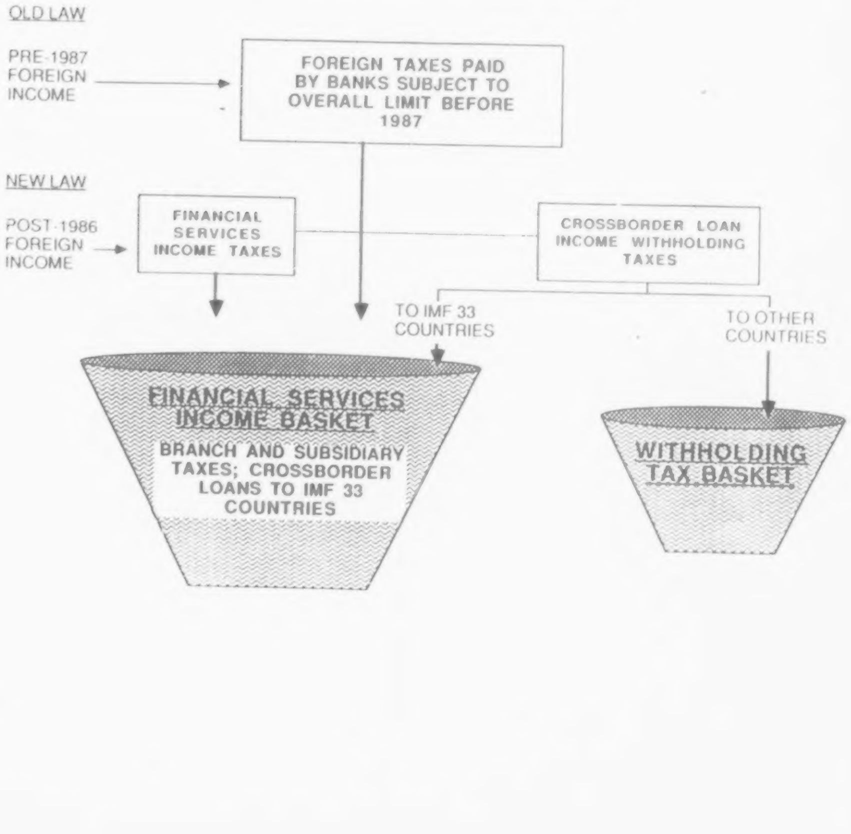
DRAFT TECHNICAL CORRECTION FOR FINANCIAL SERVICES INCOME FOREIGN TAX CREDIT CARRYFORWARDS FROM PRE-1987 YEARS

( ) Subclause (II) of section 904 (d)(2)(I)(ii) (relating to transitional rule) is amended by inserting "(determined without regard to clause (iv) of subparagraph (C))" immediately after "financial services income".

NEW LAW TREATMENT OF FOREIGN TAXES PAID BY BANKS BEFORE 1987


ALL FOREIGN INCOME TAXES PAID
NEW LAW
FOREIGN TAXES PAID BY BANKS (SUBJECT TO OVERALL LIMIT BEFORE 1987)
RECHARACTERIZE AS FINANCIAL SERVICES, INCOME TAXES, OR WITHHOLDING (CROSS BORDER LOAN) TAXES
REGULAR TAXES ON BRANCHES AND SUBSIDIARIES
WITHHOLDING TAXES ON CROSS BORDER LOANS (INCLUDING IMF 33 COUNTRY LOANS)
FINANCIAL SERVICES INCOME BASKET
INCOME FROM BRANCHES AND SUBSIDIARIES; CROSS BORDER LOANS TO IMF 33 COUNTRIES
WITHHOLDING TAX BASKET
LOW BANK INCOME
OVERALL BASKET
NO BANK INCOME!
TRASH

PROPOSED TECHNICAL CORRECTION


OLD LAW
PRE-1987 FOREIGN INCOME
FOREIGN TAXES PAID BY BANKS SUBJECT TO OVERALL LIMIT BEFORE 1987
NEW LAW
POST-1986 FOREIGN INCOME
FINANCIAL SERVICES INCOME TAXES
CROSSBORDER LOAN INCOME WITHHOLDING TAXES
TO IMF 33 COUNTRIES
TO OTHER COUNTRIES
FINANCIAL SERVICES INCOME BASKET
BRANCH AND SUBSIDIARY TAXES; CROSSBORDER LOANS TO IMF 33 COUNTRIES
WITHHOLDING TAX BASKET

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July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to urge consideration of a technical correction that would modify or eliminate the separate foreign tax credit limitations for dividends from each noncontrolled section 902 corporation.

As you know, these separate foreign tax credit limitations were not included in either the House or the Senate bill. Rather, both bills determined the proper limitation by "looking through" dividend payments to the underlying earnings in all cases where the U.S. shareholder had a direct investment in the foreign corporation (i.e. owned at least a 10 percent voting stock interest). This treatment differed from portfolio-type investments in foreign corporations, the dividends from which were treated as passive income. I have been told that these provisions were modified in Conference primarily to simplify the foreign tax credit rules and because of technical concerns that taxpayers might not be able to obtain sufficient information from foreign companies in which they hold less than a majority interest to comply with a look-through rule. The addition of the separate limitations for dividends from each noncontrolled section 902 corporation did not affect the revenue estimate for the foreign tax credit provisions.

Increasingly each year, a large number of U.S. companies undertake international corporate joint venture arrangements. These arrangements are undertaken by U.S. companies to assist in penetrating specific foreign markets (particularly in less developed countries where local ownership is often required), and to take advantage of foreign company technology and manufacturing or marketing expertise. Typically these arrangements are organized by establishing a separate joint venture corporation with the U.S. company owning 50 percent or somewhat less of the total outstanding stock.

The separate limitations for dividends from each uncontrolled section 902 corporation will apply in all of these joint venture arrangements organized in corporate form as long as the U.S. shareholder owns 10 to 50 percent, inclusive, of the foreign corporation. Because a separate limitation applies for each noncontrolled section 902 corporation and there are no "high-tax kick out" provisions, more stringent restrictions are imposed than are faced by U.S. companies that own either more than 50 percent or less than 10 percent of a foreign corporation. Moreover, because some (but not all) taxpayers can take reasonable tax planning steps to avoid the separate limitations for dividends from each section 902 corporation, this both serves as a trap for the unwary and creates arbitrary results. Finally, given other provisions in the foreign tax credit limitation enacted in the 1986 Act, these separate limitations are unnecessary for technical reasons and can be eliminated or modified without undercutting any underlying tax policy principles.

Technical Background

Both the House and Senate versions of the Tax Reform Act of 1986 applied so-called "look-through" rules to dividends and other payments of foreign corporations as long as the U.S. shareholder corporation was eligible to receive deemed paid credits under section 902 with respect to any dividends from that foreign corporation. Thus, the look-through rules generally applied with respect to payments from all foreign affiliates in which U.S. companies owned 10 percent or more of the stock. H.R. 3838, § 601(b) (House bill); H.R. 3838, § 901(b) (Senate bill). This 10 percent threshold reflected the notion that if a U.S. shareholder owned less than a 10 percent interest, it was most properly treated as a portfolio investment with respect to which passive treatment of dividends was appropriate. If, on the other hand, a U.S. shareholder had a ten percent or greater interest in a foreign corporation, it was a direct investment with respect to which active income treatment of dividends was appropriate as long as the corresponding earnings of the foreign corporation were attributable to active income. Thus, the 10 percent dividing line between direct and portfolio investments was the threshold used to trigger application of the look-through rule.

Application of the look-through rule when a U.S. shareholder owned a 50 percent or less interest in a foreign corporation complicated the operation of the rule substantially. Moreover, it required U.S. shareholders to obtain relatively detailed financial information from foreign corporations that they did not control. In Conference the staffs apparently determined that in view of these administrative difficulties, a look-through rule should generally apply only to corporations that are treated as controlled foreign corporations ("CFCs").[1] Limiting the application of the rule both ensured that taxpayers could obtain the information needed from foreign corporations to apply the look-through rule, and simplified the application of the look-through rule by limiting its application in situations where Subpart F did not also apply. H. Rep. No. 841, 99th Cong., 2d Sess. II-573 and II-583 (1986). Under the Senate and Conference versions of the bill, CFCs were foreign corporations in which U.S. shareholders in the aggregate had more than a 50 percent interest.

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[1] The Conference Report and General Explanation also state a rationale that in the case of a non-CFC, "Congress did not believe there is a sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business . . ." and therefore properly subject to the look-through rules. General Explanation at 868. This rationale is, however, inconsistent with general Code principles that such cases are properly treated as direct investment for which corporate level double taxation is considered inappropriate (under section 902). Moreover, it is inconsistent with the stated rationale for the look-through rule itself, which is to "reduce disparities that might otherwise occur [compared to] . . . income subject to a particular limitation when the taxpayer earns income abroad directly (as through a foreign branch). . . ." General Explanation at 866. Obviously the proper analogy to earning the income directly in the case of a joint venture corporation is to a joint venture partnership, where the equivalent of a look-through rule clearly applies even if the U.S. partner owns a 50 percent or less interest.

Limiting the application of the look-through rule to CFCs raised the issue of how to apply the new foreign tax credit limitations to U.S. shareholders with respect to direct investments in foreign corporations in which they owned at least a 10 percent interest, but not more than a 50 percent interest. The solution adopted was a separate foreign tax credit limitation for each corporation paying such dividends.

Several problems result from this solution. While many well-advised U.S. shareholders can plan around the separate limitations, other shareholders -- for business reasons completely unrelated to tax considerations -- cannot. Those which cannot, where they own 10 to 50 percent of a foreign corporation, are left with a tax treatment under section 904 which is more adverse than if they owned either more than 50 percent or less than 10 percent. The treatment is also more adverse than that had the joint venture been organized as a partnership rather than a foreign corporation. The adverse treatment applies even though the activities and investments of a foreign corporation are substantially the same as that of other joint venture investments which have been able to avoid the separate limitations.

From either a policy or a technical viewpoint, such a solution makes little sense. Moreover, from a technical point of view, it is submitted that with time for more deliberate thought, other less harsh solutions are available to the problems faced in Conference.

Possible Alternative Provisions

Election to be Treated as a CFC. It is generally in the U.S. Government's long-term interest that foreign corporations with substantial U.S. ownership be treated as controlled foreign corporations. Such corporations must comply with extensive U.S. reporting requirements. They are not allowed deferral on various types of "tax haven" income. Further, gain from the sale of stock of such corporations, to the extent of unrepatriated earnings and profits, is treated as a dividend and is not eligible for any capital gains treatment that may from time to time exist.

Notwithstanding these favorable aspects from the U.S. Government viewpoint, taxpayers in most circumstances would elect CFC status if permitted in order to avoid the separate limitations on dividends from each noncontrolled section 902 corporation. The election could be conditioned on the availability of sufficient information to apply and enforce the look-through rules, Subpart F, and other provisions. The election could further be made irrevocable except with the consent of the Commissioner.

Such an election would remove the penalty element inherent in the separate limitations for each noncontrolled section 902 corporation dividends. Particularly if revocable only with consent, taxpayers making the election might well do so to avoid the penalty aspects of the separate limitation without significant regard to the precise long-run impact on future U.S. tax liabilities under Subpart F.

Passive Income Treatment. As an alternative (or in addition) to an election of CFC status, the separate limitations for each noncontrolled section 902 corporate dividends could be eliminated and such amounts treated in all cases as passive income in the same way that dividends from corporations in which the U.S. shareholder owns less than 10 percent are treated. Such treatment would significantly simplify the foreign tax credit rules: only two systems of limitations would exist -- one for all CFC dividends and one for non-CFC dividends. Moreover, any concerns that excess credits from high-taxed dividends of non-CFC corporations could be used to eliminate U.S. tax on other passive income is automatically avoided because the final legislation (unlike the Senate bill and apparently early versions of the Conference agreement) includes the so-called high-tax kick out of section 904(d)(2)(A)(iii)(III). The technical corrections legislation could state clearly that, like with dividends from CFCs, taxes deemed paid by U.S. shareholders with respect to dividends of non-CFCs would be taken into account in determining whether the high-tax kick out applies. Passive income would thus not be sheltered by high-tax dividends. Instead, the dividends would be treated as any other kind of income from non-CFC investments.

Either (or both) of the above approaches would simplify the foreign tax credit separate limitation provisions from a technical point of view and would eliminate the unnecessarily harsh and discriminatory treatment now provided for dividends from companies whose U.S. ownership ranges from 10 to 50 percent. They ought to be given serious consideration in technical corrections.

Sincerely,

Paul W. Oosterhuis

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July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office
Building
Washington, D.C. 20515

Re: Application of the Look-Through Rule to Gain on the Sale of Stock of a CFC

Dear Mr. Leonard:

We are submitting this statement on behalf of USG Corporation to request a technical correction to the Tax Reform Act of 1986 (the "1986 Act") that would permit the "look-through" rule of section 904(d)(3) to apply to characterize all of the gain from the sale of stock of a controlled foreign corporation ("CFC") for purposes of the separate foreign tax credit limitation provisions. Under the 1986 Act, the look-through rule applies arguably only to the extent the gain constitutes a dividend under section 1248.

1986 Act Provisions

Gain from the sale of stock of a CFC will generally be foreign source income under section 865(f). The characterization of such gain for separate foreign tax credit limitation purposes is derived from several provisions. Under section 954(c), gain from the sale of property which gives rise to passive-type income (e.g., dividends) constitutes foreign personal holding company income. Under section 904(d)(2)(A)(i), income of a kind which would be foreign personal holding income is characterized as passive income for separate foreign tax credit limitation purposes. Thus, absent some special rule, the gain from the sale of stock of a CFC could be interpreted to fall within the separate foreign tax credit limitation category for passive income.

The look-through rule in section 904(d)(3), however, applies to modify this application of the separate foreign tax credit limitation categories with respect to various types of income received from a CFC. Under this rule, dividends paid by a CFC are treated as income in a separate limitation category only in proportion to the ratio of earnings and profits of the CFC falling within the same limitation category. If none of a CFC's earnings and profits are attributable to separate limitation items, none of the dividends paid by the CFC with respect to its stock will fall within a separate limitation category for foreign tax credit purposes. In other words, if all of a CFC's earnings and profits are attributable to manufacturing income that comes within the overall foreign tax credit limitation, all of the dividends paid by the CFC to a U.S. shareholder would be treated as income subject to the overall foreign tax credit limitation.

As the term is used in this look-through provision, "dividend" includes any amount treated as a dividend under section 1248. S. Rep. No. 313, 99th Cong., 2d Sess. 314 (1986); H.R. Rep. No. 841, 99th Cong., 2d Sess. II-581 (1986). Under section 1248, gain from the sale of stock of a CFC constitutes a dividend to the shareholder, but only to the extent the CFC has earnings and profits attributable to such stock which were accumulated in taxable years of the CFC beginning after 1962, and during the period or periods the stock sold was held by the shareholder while the CFC was in fact a CFC (the "section 1248 amount"). Thus, gain on the sale of stock of a CFC constitutes a dividend and is characterized under the look-through rule for dividends in section 904(d)(3)(D), but only to the extent of the CFC's post-1962 earnings and profits attributable to the stock sold. Any gain in excess of the section 1248 amount (reflecting appreciated assets owned by the CFC) is not treated as a dividend, is not characterized under the look-through rule, and thus arguably remains characterized as passive income subject to the separate foreign tax credit limitation for passive income.

Discussion

The above interpretation of the look-through rule (i) is inconsistent with the policies underlying that rule, (ii) creates a trap for the unwary, and (iii) leads to arbitrary results. Consequently, we urge that a technical correction be enacted to apply the look-through rule to characterize all of the gain on the sale of stock of a CFC. A look-through rule could be crafted to characterize such gain as if it were gain on the sale of the underlying assets of the CFC.

Policies for Establishing a Look-Through Rule

The look-through rule was added as part of the 1986 Act's overhaul of the foreign tax credit provisions to reflect Congress' understanding that a taxpayer's stock interest in a CFC represents part of that taxpayer's multinational business operations and not merely a portfolio investment. As the *General Explanation* explains, "[a] primary function of look-through treatment is to make the foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent." *General Explanation*, at 866. Thus, the look-through rule was added to permit items that would otherwise be viewed as separate limitation items in the hands of a taxpayer owning stock in a CFC to be characterized after taking into account the character of the income at the CFC level. Through this mechanism, income earned by a CFC could be treated as if the CFC were a branch of a taxpayer, rather than a subsidiary.

In order to be consistent with this stated rationale, income from the sale of a taxpayer's stock in a CFC should be characterized as if the CFC were a foreign branch. Because the stock represents the underlying assets of the CFC, characterization of the gain for foreign tax credit purposes should depend on the character of the gain which would be realized on a sale of the assets of the CFC.

If all of a CFC's assets were used in an active manufacturing operation that was conducted through a foreign branch rather than a foreign subsidiary, it is clear that any gain realized on the sale of the assets by the U.S. parent would be active income and would not fall within the separate foreign tax credit limitation category for passive income. Similarly, any gain realized on the sale of stock in a CFC that conducts the same business activity should also be characterized as active income. In this way, income earned by the CFC that is reflected in the gain on the sale of the stock would be treated as if it had been earned directly by the shareholder. A look-through rule that achieves this result would be consistent with the stated purpose for the look-through rule of section 904(d)(3).

Traps for the Unwary

In many cases, taxpayers selling stock of a CFC will be able to achieve the same results that the current look-through rule provides through the use of careful tax planning. Thus, the absence of a look-through rule that applies to characterize all of the gain from the sale of stock of a CFC will largely serve as a trap for taxpayers not aware of these various planning opportunities.

Because the section 1248 amount is accorded look-through treatment, taxpayers can reduce their passive income by increasing the section 1248 amount portion of the gain realized on the sale of stock of a CFC. This result can be accomplished in many ways. For example, a CFC that has appreciated assets can sell some of its assets prior to the sale of its stock by the taxpayer. The gain realized by the CFC will increase its earnings and profits and, therefore, the section 1248 amount. See Treas. Reg. 1.312-6(b). On a subsequent sale of the stock of the CFC, more of the gain will be attributable to the section 1248 amount and thus be eligible for look-through treatment.

Another alternative would be to structure the transaction as a sale of the CFC's assets rather than stock, followed by a distribution of the proceeds to the shareholders of the CFC. The asset sale would increase the earnings and profits of the CFC.[1] A subsequent distribution of the proceeds to the shareholders would cause most (if not all) of the proceeds to be characterized under the look-through rule for dividends set forth in section 904(d)(3)(D). The income earned by the CFC on the sale of assets would be characterized for foreign tax credit limitation purposes as if the CFC had been operated as a foreign branch.

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[1] Section 1248(d)(2) provides that the gain from the sale of assets is to be excluded from the earnings and profits of a CFC if the CFC adopts a plan of liquidation in a taxable year beginning after 1962, and if section 337 would apply if the CFC were a domestic corporation. In view of the repeal of General Utilities and corresponding amendments made by the Tax Reform Act of 1986, this provision has been declared "deadwood," and proposed for repeal in the Technical Corrections Act of 1987. See Section 106(e)(14)(A), H.R. 2636, 100th Cong., 1st Sess (1987); Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350), Joint Committee on Taxation, 46 (1987). Even if section 1248(d)(2) remained, however, a sale of assets and distribution of proceeds could be constructed that would not fall under section 337. Thus, it would not operate to prohibit taxpayers from increasing the earnings and profits of a CFC.

Taxpayers also can increase the portion of the gain characterized under the look-through rule on the sale of the CFC's stock in a transaction that satisfies the requirements of section 338. In such a case, the deemed sale of the CFC's assets that results from a section 338 election will increase the earnings and profits of the CFC, therefore increasing the section 1248 amount that is treated as a dividend. Temporary Treas. Reg. § 1.338-5T(g). Thus, the portion of the gain realized on the sale of stock of a CFC subject to the look-through rule in section 904(d)(3)(D) will be increased any time a section 338 election is made with respect to a qualified stock purchase.

With all of these planning opportunities available, it is the unsophisticated taxpayer that will be most affected by the current limitation on the availability of the look-through rules.

Arbitrary Results

The ease with which taxpayers can modify their tax consequences simply by changing the structure of their stock sale transactions demonstrates the arbitrary nature of the rule as currently drafted. A further inconsistent and arbitrary aspect of the current provision is the treatment given pre-1963 earnings and profits. By applying the look-through rule only to the section 1248 amount portion of a gain, section 904(d)(3)(D) effectively treats earnings and profits accumulated by a CFC in taxable years of the CFC beginning in 1962 or earlier years as passive income, regardless of the type or nature of the income that created these earnings and profits. If, however, the pre-1963 earnings and profits were simply distributed as dividends by the CFC to its shareholders, they would be characterized for separate foreign tax credit limitation purposes under the look-through rule. That rule, as interpreted by the Service in Notice 87-6, 1987-3 I.R.B. 8, would generally treat dividends out of pre-1963 earnings and profits as subject to the overall limitation.

Recommendation

To eliminate potentially arbitrary results (as well as traps for the unwary) and to make the treatment of the sale of stock in a CFC consistent with the underlying foreign tax credit policies, section 904(d)(3) should be amended to provide that the look-through rule of section 904(d)(3) applies to all gain from the sale of stock of a CFC. The rule can be administered without undue difficulty by providing that, with respect to a CFC that generates income subject to the overall foreign tax credit limitation, gain on the sale of the stock of the CFC will be subject to the overall limitation except to the extent that the value of any passive assets held by the CFC at the time of the stock sale exceeds their basis for earnings and profits purposes. This rule would assure that taxpayers using a stock sale to dispose of their interest in a CFC would receive no more beneficial treatment than if an asset sale had occurred, and would eliminate the arbitrary results that exist in the law as presently drafted.

Sincerely,

Paul W. Oosterhuis

Patricia M Lacey
Patricia M. Lacey

Section 1211

LANE AND EDSON, P. C.

MEMORANDUM

TO: Robert J. Leonard
Chief Counsel
Committee on Ways and Means

H. Patrick Oglesby
International Tax Counsel
Joint Committee on Taxation

FROM: Michael J. Kliegman
Lane and Edson, P.C.

DATE: July 15, 1987

RE: Technical Corrections Act of 1987, Section 112(d) and (y)
Tax Reform Act of 1986, Section 1211

We wish to bring to your attention a serious technical problem that is inherent in Section 1211 of the Tax Reform Act of 1986 (the "1986 Act") but is exacerbated by Section 112(y) of the proposed Technical Corrections Act of 1987 (the "Bill"). The issue involves the application of the new foreign tax credit source rules to perpetual, exclusive licenses of foreign intangibles.

In Section 1211 of the 1986 Act, Congress enacted new rules, contained in Section 865 of the Internal Revenue Code, to determine the source of income from sales of personal property. The general rule, contained in Section 865(a), is that sales of personal property by U.S. residents are sourced in the U.S. This reversed the long-standing rule, contained in former Sections 861(a)(6) and 862(a)(6) of the Code, and further codified in a number of our income tax treaties, that looked to the place of sale for the source of the income. As described in the committee reports and Joint Committee Explanation, the purpose of the change was to prevent transactions generating no foreign tax from increasing a U.S. resident's foreign-source income.

The 1986 Act provides several exceptions to the new "residence of the seller" rule. Two that are relevant here are Section 865(d), pertaining to intangibles, and Section 865(f), pertaining to stock of foreign affiliates. Under the former provision, foreign sourcing is essentially available where a U.S. resident sells foreign goodwill, or sells intangibles for a contingent price based upon use outside the U.S. Similarly, the latter provision allows a foreign source for the sale of stock in an active foreign subsidiary.

Although similar to the above exceptions and worthy of the same treatment, the following situation has apparently fallen through the legislative cracks. There is a long-standing case law doctrine that a license-royalty arrangement will be treated as a sale of the intangible where the "licensor" has effectively transferred to the "licensee" all substantial right and interest in the intangible in a particular territory. See, *e.g.*, *Hooker Chemicals and Plastics Corporation v. United States*, 591 F.2d 652 (Ct. Cl. 1979); *Conde Nast Publications, Inc. v. United States*, 575 F.2d 400 (2d Cir. 1978); Rev. Rul. 64-56, 1964-1 (Part I) C.B. 133. This principle has been codified liberally with respect to patents in Section 1235 of the Code.

Thus, United States tax laws will often characterize purported licenses of patents, trademarks and other intangibles as sales of capital assets. It will often be the case, however, that the foreign jurisdiction in which the licensee resides, and in which the intangibles will be used, will apply a more formalistic interpretation to the arrangement and exact a withholding tax, even on a lump-sum "royalty" that will not be treated as a royalty in the United States. In a transaction recently undertaken by our U.S. client, a foreign buyer acquired both stock in a foreign affiliate and intangibles not owned by the foreign affiliate itself. Although for non-tax business reasons the transfer of patents, trademarks and know-how was handled via a perpetual, exclusive license, the arrangement in fact closely resembles a sale of goodwill and of the underlying stock itself; there is little doubt but that "sale" treatment will be required under applicable U.S. case law.

For a United States seller to be denied a foreign tax credit under the above circumstances is inequitable and contrary to Congress's purpose in modifying the source rules.

The transaction referred to above was closed in the foreign jurisdiction, and a withholding tax was paid on the license of intangibles. It has been our expectation that, in spite of the fact that relief from U.S. sourcing was not contained in new Code Section 865, we could rely on the applicable treaty provision setting forth a "place of sale" rule for foreign tax credit purposes. Because of the imposition of a foreign tax on the transaction, we would not be running afoul of language, contained in the House and Senate Reports to H.R. 3838, that treaty source rules should not be read to allow "untaxed income [to] increase a U.S. taxpayer's foreign tax credit limitation." In light of Section 7852(d) of the Code, and the longstanding rule that legislative overriding of treaties is only found when the intention to do so is clearly expressed, see *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984), *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 413 (1967); Rev. Rul. 80-223, 1980-2 C.B. 217; we have believed that we would be able to credit the foreign withholding tax against U.S. taxes paid.

Section 112(y) of the Bill proposes an extensive revamping of Section 7852(d) of the Code. Specifically, it reverses the basic presumption that treaty provisions have continuing validity notwithstanding later legislative changes. As noted above, current law allows Congressional overriding of treaties, where and to the extent such Congressional intent is clearly and unambiguously manifested. Without arguing the merits of this issue *per se*, it should suffice to state that the proposed amendments to Section 7852(d) would reverse an unquestionably sensible reading of prior law, and should not be retroactively applied to the facts that are outlined above.

Conclusion

The technical problem faced by our client and others similarly situated can be corrected in one of the following ways. The most direct would be to amend Section 865(d) to provide that sales of intangibles that incur a foreign "royalty" tax will be sourced, like goodwill and royalties, in the foreign jurisdiction. A more limited, transitional relief, for those who have reasonably relied upon treaty source rules, would be to allow treaty source rules to apply to transactions that, prior to the enactment of the Bill, in fact incurred foreign taxes. The requirement of a foreign tax on the transaction will limit such a relief provision to those within the general scope of Congressional intent.

Because both of the above modifications merely protect transactions that the 1986 Act was not intended to adversely affect, they should not involve any loss of revenue.

Section 1214

ROBERT T. MATSUI
THIRD DISTRICT, CALIFORNIA

COMMITTEE ON
WAYS AND MEANS

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July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This responds to your request for suggestions for additional technical corrections. Section 1214 of the Tax Reform Act amended Sections 861(c), 871(i) and 881(d) of the Internal Revenue Code to change the rules regarding the determination of whether dividends and interest paid by certain domestic corporations to their foreign shareholders are derived from sources within or outside the United States. One unintentional consequence of this change was the elimination of the U.S. withholding tax exemption for dividends paid to foreign shareholders by United States mutual funds qualifying as so-called "80-20" corporations" prior to the adoption of the Act.

Under the previous law, dividends paid by a Unted States corporation to its foreign shareholders were entirely exempt from United States withholding tax if the corporation derived more than 80% of its aggregated gross income for a specified period from sources outside the United States (an "80-20 Corporation"). Several United States investment companies that have elected to be taxed as regulated investment companies ("RICs") qualified as 80-20 Corporations under the previous law because they invest substantially all their assests in foreign bank deposits and other foreign debt obligations.

Subject to a transitional rule, Section 1214, by changing the basis for determining the source of dividends paid by 80-20 Corporations, inadvertently precludes RICs that could have qualified as 80-20 Corportions under the prior law from now qualifying for an exemption from United States withholding tax on dividends paid to their foreign shareholders. Once the transitional rule has expired, these RICs likely will be unable to retain their foreign shareholders and, therefore, will probably either dissolve or move off-shore if the Act is not amended to restore the exemption from the United States withholding tax.

I have attached a memorandum which provides a detailed analysis of this issue including a discussion of "tax treaty shopping", an issue raised by the Treasury Department, and two alternative proposed technical amendments.

Very Truely Yours,

Bob

ROBERT T. MATSUI
Member of Congress

STATEMENT OF PROBLEM

Section 1214 of the Act generally repeals the special statutory sourcing rules previously applicable to 80-20 Corporations and treats all dividends paid by a United States corporation as United States source income. Section 1214 nevertheless provides that such dividends will continue to be exempt from United States withholding tax imposed on certain categories of United States source of income (1) if at least 80% of the aggregate gross income derived by the corporation during a specified "testing period" consists of "active foreign business income," and (2) only to the extent that the gross income derived by the corporation during this period consists of foreign source income. The term "active foreign business income" is defined for this purpose to mean gross income which is "attributable to the active conduct of a trade or business in a foreign country." While no clear guidance on this definition is provided in the Act or the legislative history, it appears unlikely that these RICs would be treated as engaged in the "active" conduct of a business outside of the United States for this purpose.

Section 1214 of the Act also provides a special transitional rule with respect to this "active foreign business" exception. With respect to determining the extent to which a United States withholding tax would be imposed on dividends paid by an 80-20 Corporation to a foreign shareholder in a taxable year of such corporation beginning before January 1,1988, this transistional rule eliminates the requirement that at least 80% of the income of the 80-20 Corporation must consist of "active foreign business income". This transitional rule has the effect of continuing for a short time period the special income source rule existing under prior law for dividends paid by 80-20 Corporations to foreign shareholders.

There is no indication in either Section 1214 of the Act or its legislative history that Congress intended to impose a United States withholding tax on dividends paid to foreign shareholders by an 80-20 Corporation where the income derived by the 80-20 Corporation would not have been subject to such tax if derived directly by those sheareholders. The legislative history of the Act indicates that Section 1214 of the Act was enacted primarily to address Congress' concerns that (1) the special income sourcing rules previously applicable to dividends and interest paid by 80-20 Corporations ceded primary tax jurisdiction away from the United States for income that should have been borne a United States tax, and (2) certain United States taxpayers were utilizing 80-20 Corporations to artificially inflate their available foreign tax credits. See, e.g., Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, pp. 937-938. Neither of these concerns exist with respect to dividends paid to their foreign shareholders by RICs qualifying as 80-20 Corporations.

Discussion of Proposed Technical Amendments to Section 1214 of the Act

The two alternative amendments to Section 1214 of the Act that I am proposing herein would expressly continue the prior United States withholding tax exemption for dividends paid to foreign shareholders by RICs qualifying as 80-20 Corporations, at least to the extent of the foreign source income derived by a RIC during the three-year period ending with the taxable year within which the dividends are distributed. These amendments would not alter the other provisions of Section 1214 which generally treat dividends and interest paid by 80-20 Corporations as income derived from sources within the United States for all other Federal income tax purposes.

If one of these two technical amendments is not included in the Technical Corrections Bill the foreign shareholders of RICs qualifying as 80-20 Corporations likely will withdraw all of their funds from these RICs and reinvest in mutual funds organized outside of the United States. This shift in investment would benefit the foreign investment advisory community to the detriment of their United States counterparts which service RICs qualifying as 80-20 Corporations.

The first proposed technical amendment would exempt RICs which qualified as 80-20 Corporations under prior law from the new rules contained in Section 1214 of the Act solely for purposes of the withholding tax imposed on dividends paid by United States corporations to foreign shareholders. This amendment would have the effect of permitting these RICs to continue to pay dividends to their foreign shareholders without the imposition of any United States withholding tax.

The alternative proposed technical amendment would have the effect of permitting RICs qualifying as 80-20 Corporations under prior law to permanently rely on the special transitional rule contained in Section 1214 of the Act by making the new "active foreign business income" requirement referred to above permanently inapplicable to RICs. While not as advantageous to RICs as the first alternative, this amendment would allow some RICs qualifying as 80-20 Corporations under prior law to continue in business.

The alternative technical amendments proposed herein should not result in any revenue loss to the United States Treasury. After the termination of the special transitional rule noted above, Section 1214 of the Act will not raise any revenue from RICs qualifying as 80-20 Corporations since, as noted above, these RICs simply will move offshore or terminate their existence if the provision is not changed in the manner suggested herein. Conversely, the amendments proposed herein would not cause a loss in revenue because they merely maintain the status quo existing prior to the Act (i.e., no United States withholding tax would be imposed on dividends paid to foreign shareholders by RICs qualifying as 80-20 Corporations).

Discussion of Alleged "Tax Treaty Shopping"

In considering these alternative technical amendments, I understand that the Treasury Department has expressed some concern that these amendments may have the effect of encouraging certain foreign shareholders of the RICs involved to invest in these funds for the purpose of "tax treaty shopping". Specifically, I understand that the Treasury Department believes that certain foreign shareholders invest in RICs qualifying as 80-20 Corporations for the primary purpose of avoiding the imposition of a withholding tax by the foreign countries in which the issuers of the debt instruments acquired by the RICs are resident. The Treasury Department's concern apparently is premised on the assumptions that (1) the foreign shareholders of these RICs would be subject to such foreign withholding taxes if they were to invest in those debt instruments directly, and (2) these foreign shareholders can avoid the imposition of such foreign withholding taxes by investing in a RIC qualifying as an 80-20 Corporation by reason of the interest withholding exemptions set forth in the provisions of income tax treaties between the United States and these foreign countries.

I do not believe that the "tax treaty shopping" abuse raised by the Treasury Department exists. Contrary to the Treasury Department's first assumption, most of the foreign countries in which the issuers of the debt obligations held by these RICs are resident do not impose any withholding tax on interest payable on the bank deposits and certain other debt obligations of entities resident in their country. Such foreign withholding tax exemptions are similar to the statutory exemptions from United States withholding taxes for interest payable to foreigners with respect to bank deposits and for "portfolio interest". See sections 871(i), 871(h) and 881(i) of the Internal Revenue Code. Therefore, the foreign shareholders of RICs qualifying as 80-20 Corporations under prior law could invest directly in many of the foreign debt instruments acquired by these RICs without themselves being subject to any foreign withholding taxes. In these cases, these foreign shareholders are not in any way taking advantage of the provisions of any income tax treaty to which the United States is a party.

Further, foreign individuals and entities have generally invested in the RICs that qualified as 80-20 Corporations for the purpose of short-term cash management. For example, at any one time, the investments of these RICs consist of debt instruments issued by issuers resident in a number of different countries and the average maturity of these debt instruments generally is less than 45 days. Since the composition of the investment portfolio of these RICs constantly is changing based upon the market conditions existing in the various foreign countries involved, the foreign shareholders of these RICs do not know the precise nature of the RIC's investments at any time and cannot properly be regarded as using the RICs primarily as a "tax treaty shopping" vehicle. Shareholders are not informed prospectively of the RIC's investments and, therefore, would not be able at the time of the investment to determine the identity of the foreign country in which the issuers of the debt instruments owned by the RIC are resident.

Nevertheless, the two alternative technical amendments to Section 1214 of the Act that I am proposing address the Treasury Department's concern. This is accomplished by denying the applicability of these amendments to any RIC with respect to any taxable year in which more than 50 percent of the total value of the RIC's assets for the year are invested in assets the income from which is exempt from foreign withholding taxes solely by reason of the provisions of an income tax treaty between a foreign country and the United States. Therefore, any RIC which fails this 50% asset test would be deemed to be party to "tax treaty shopping" by its foreign shareholders and the dividends paid by such a RIC to these foreign shareholders would be subject to a United States witholding tax under the Act.

Alternative Proposed Technical Amendments to Section 1214 of the Tax Reform Act of 1986 (the "Act")

I. Proposed Transitional Rule Amendment to Section 1214(d) of the Act for Regulated Investment Companies

The following clause (i) should be added to section 1214(d)(4)(A) of the Act and the existing language in subparagraph (A) should become clause (ii):

(4) CERTAIN DIVIDENDS

(A) IN GENERAL

"(i) For purposes of sections 871, 881, 1441 and 1442, the amendments made by this section shall not apply to any dividend paid or accrued by a regulated investment company which was incorporated on or before December 31, 1985 and which demonstrates to the satisfaction of the Secretary that less than 20 percent of the gross income from all sources of such corporation has been derived from sources within the United States (as determined under the provisions of subchapter N) for the 3-year period ending with the close of the taxable year of such corporation preceding the payment of such dividend (or for such part of such period as may be applicable).

The preceding sentence shall not apply to any regulated investment company with respect to any taxable year in which more than 50 percent of the value of the total assets of the company is at any time during such year invested in assets the income from which is exempt from any income or withholding tax imposed by a foreign country solely by reason of the provisions of an income tax treaty between the United States and such foreign country".

II. Proposed Amendment to Section 861(c)(1)(B) of the Internal Revenue Code

The following sentence should be added after clause (ii) of section 861(c)(1)(B) Internal Revenue Code:

"For purposes of clause (ii), the gross income derived by a regulated investment company from sources outside the United States (as determined under this subchapter) shall be treated in all cases as attributable to the active conduct of a trade or business in a foreign country or possession of the United States by such company. The preceding sentence shall not apply to any regulated investment company with respect to any taxable year in which more than 50 percent of the value of the total assets of the company is at any time during such year invested in assets the income from which is exempt from any income or withholding tax imposed by a foreign country solely by reason of the provisions of an income tax treaty between the United States and such foreign country."

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July 2, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Dear Mr. Chairman:

I am writing in regard to a technical problem with the new source rules for dividend and interest income adopted in the Tax Reform Act of 1986. The problem is not controversial, and I hope it can be addressed in the Technical Corrections Act of 1987.

Section 1214 of the Reform Act changes the pre-existing statutory scheme for "80-20" companies, principally by adopting new "foreign business requirements." Those requirements in Code section 861(c) in turn control the exemption for dividends paid to foreign persons under Code sections 881(d) and 871(i)(2)(B) as well as the source of interest paid to all persons under Code section 861(a)(1)(A).

Code section 861(c)(1) now provides that an individual or corporation meets the 80-percent foreign business requirements if at least 80 percent of its gross income from all sources during a three-year testing period is "active foreign business income." The Conference Report which accompanied the Reform Act states, at p. II-602, that these requirements may be met by a domestic corporation alone "or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest . . . ." The Report indicates that the conferees intended the character ("i.e., foreign active business income") of the subsidiary's gross income to be attributed to the corporate shareholder on the receipt of dividends:

> Thus, dividends received by a corporate shareholder from controlled U.S. subsidiaries, though treated as U.S. source, are to be characterized as foreign active business income in the same proportion that the controlled subsidiaries' foreign active business income bears to their total gross income . . . .

These statements make clear that the active foreign business of a subsidiary is attributed to a controlling corporate shareholder for the purpose of testing dividends and interest paid by that shareholder under the revised version of the 80-20 rule.

The language of the Code, however, is not nearly so clear as the legislative history. Section 861(c)(1)(B) provides that "active foreign business income" means gross income which is both "derived from sources outside the United States" and "attributable to the active conduct of a trade or business in a foreign country or possession of the United States by the individual or corporation . . . ." The second requirement, situated in section 861(c)(1)(B)(ii), contains the added parenthetical language "or by a subsidiary or chain of subsidiaries of such corporation." The first requirement ("derived from sources outside the United States") contains no such reference to subsidiaries.

Thus, dividends paid by a domestic subsidiary to a domestic parent corporation arguably may not be characterized as "active foreign business income" to the parent, even though the subsidiary satisfies the 80-percent foreign business requirements. Although the dividends clearly would be "attributable to the active conduct of a trade or business in a foreign country," as required by section 861(c)(1)(B)(ii), the dividends would be derived from sources within the United States, because the payor (the subsidiary) is a domestic corporation and the general rule of section 861(a)(2)(A) is that dividends paid by a U.S. corporation have a U.S. source.

The inconsistency between the Act and the Conference Report is due exclusively to the absence of a statutory rule attributing the foreign source of a domestic subsidiary's active foreign business income to its parent for purposes of section 861(c)(1)(B). The Conference Report clearly contemplates such attribution. Moreover, the issue has been brought to the attention of the Staff of the Joint Committee on Taxation, and it does not appear to be controversial.

The problem can be solved, I suggest, by adding a brief clause at the end of section 112(f)(3) of the proposed Technical Corrections Act of 1987, H.R. 2636. That section would amend section 861(c)(1)(B) in a way that is not directly relevant to the problem addressed in this letter. The proposed additional clause would read as follows:

> "For purposes of clause (i), dividends will be treated as derived from sources outside the United States if they are attributable to the income of a subsidiary which meets the 80-percent foreign business requirements of subparagraph (A)."

The proposed amendment would clearly implement the intentions of Congress as expressed in the Conference Report.

A letter similar to this one is being sent to the Chairman of the Senate Finance Committee.

Sincerely,

H. David Rosenbloom

Section 1215

Hercules Incorporated
Hercules Plaza
Wilmington, Delaware 19894

July 13, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office
Building
Washington, D. C. 20515

Re: Treatment of Export Interest

Dear Mr. Leonard:

Hercules Incorporated, Wilmington, Delaware is a multinational chemical corporation whose exports sales total $400-$500 million annually.

Over the past few years, it has become increasingly difficult to maintain our competitive market positions overseas. The primary factors are the relative strength of the dollar, the export financing facilities available to our competitors and various non-tariff barriers.

Hercules formed Hercules Finance Company Limited in 1985 overseas to provide more attractive financing to our overseas customers and other exporters.

By supplying attractive financing rates, this helped us compete more favorably with our overseas competitors. This Hercules financing facility also finances U.S. exports of other U.S. companies.

The Tax Reform Act of 1986 contains an exception to the subpart F provisions for export financing interest relating to the sale of inventory property of a related manufacturer. However, the provision as drafted is virtually meaningless because of its limitation to products of a related manufacturer and of a technical amendment made to section 864(d) of the Code which denies the export financing exception to sales of inventory property of a related manufacturer. Thus, the exception is limited to export sales of non-inventory property of a related manufacturer.

We recommend consideration of two items:

1) Remove the factoring provisions of Section 864(d) which seems to conflict with the export financing exemption provided for by the Tax Reform Act.

2) The export financing exemption is only available to related U.S. exporters. All U.S. exporters should be able to obtain favorable U.S. export financing whether related or unrelated to the overseas bank.

Enclosed is a more detailed technical memorandum.

Very truly yours,

Arden B. Engebretsen
Vice Chairman of the Board &
Chief Financial Officer

July 13, 1987

MEMORANDUM

Re: The Export Financing Exception For Subpart F Income In The 1986 Act Should Be Corrected Because As Drafted It Provides Virtually No Benefit For Exports

INTRODUCTION

For the purpose of assisting U.S. exports, the Tax Reform Act of 1986 contains an exception to the Subpart F provisions, in the case of a foreign bank, for export financing interest. This exception, however, is so narrow and questionably drafted that it provides essentially no benefit to export activities.

The exception does not apply to interest from the export financing of products produced by a person which is unrelated to the foreign bank. Further, it does not apply to interest from the export financing of any inventory property produced by a person related to the bank. The exception only applies to interest from the export financing of property initially manufactured by a related person for use in its own trade or business which it later exports.

Given the expressions of concern by the Congress over exports, it is difficult to believe that the Congress would approve an export financing exception that benefits virtually no exports. In order to make the export financing exception meaningful, in the case of a foreign bank, it is recommended that the provision be amended to apply to sales of inventory by related and unrelated persons.

BACKGROUND

The 1984 and 1986 Tax Acts have almost totally eliminated the tax benefit of deferral for a foreign bank in financing the export of U.S.-made goods of related and unrelated persons. Prior to these Acts, a foreign bank could finance the sale of export products of related and unrelated persons and the profits therefrom would not be subject to U.S. tax until distributed to the U.S. shareholders as a dividend.

Unrelated Persons - Before the 1986 legislation, interest received by a foreign bank in connection with the financing of export sales of unrelated persons was not subpart F income because the banking exception to the foreign personal holding income rules applied. The 1986 Act eliminated the banking exception. The Conference Report appears to indicate an intention that the change was not intended to have a negative impact on exports. It states that an exception for interest from export financing was included because of "concern that this tax reform legislation might otherwise have the effect of reducing the availability of export financing in some cases, which could, in turn, have a negative impact on the volume of exports". (Conference Report at 565.) However, the exception provided in the 1986 Act does not apply to exports of unrelated persons and thus, contrary to the objective stated in the Conference Report will adversely impact exports.

Related Persons - Before the 1984 legislation, interest received by a foreign bank in connection with the financing of exports sales of related persons was not foreign personal holding income because the banking exception applied. The 1984 Legislation was intended to treat factoring income from factoring a related persons trade receivables as interest income because factoring was the functionally equivalent of interest income*. The solution to the problem was to provide in section 864(d) that income from the factoring of a trade receivable is to be treated as if it were interest earned by the factor on a loan to the obligor of the receivable.

Moreover, factoring income was denied the banking exception to foreign personal holding company income. There was no reason given for treating interest income of a foreign bank from financing the sale of related persons' products as not being entitled to the banking exception. Once factoring is characterized as interest income, there is no justification for treating factoring any different than other forms of interest income. Moreover, the 1984 legislation provided that an actual loan to an unrelated person to finance sales of a related person's goods is to be treated as if it were factoring income. That is, it is to be treated as income from a factoring transaction. Of course, since factoring income is treated as interest income, the income is treated as interest income which is not eligible for the exception to subpart F income.

Finally, the 1986 Legislation appears to provide an exception to foreign personal holding income for interest from the financing of the export sale of U.S. products manufactured by a related person. However, the exception does not apply to the sale of inventory products, because the rules adopted in 1984 were made applicable the export financing exception. It is incongruous to provide an exception for exports of products of related persons and then to provide that the exception does not apply to inventory property. If there was an intention to assist the export of U.S.-made goods by providing an export financing exception, it clearly must have been intended by the policymakers that the exception applies to sales of inventory property.

IMPORTANCE OF EXPORT FINANCING

Attractive export financing rates is a key element in the sale of goods. Many foreign governments provide significant assistance to their manufacturers in making exports sales by providing export financing at a lower than market rate. The United States Export-Import Bank does not provide short-term export financing assistance to U.S. exporters. Thus, the burden of providing competitive financing rates falls on the U.S. manufacturer wishing to make the export.

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* Under prior law, the Internal Revenue Service had held that income from the factoring of a receivable was service income and not interest for purposes of the subpart F provisions of the Internal Revenue code. Accordingly, the factoring income was not included as personal holding company income. The General Explanation states that a "factoring transaction is a financing transaction in which the factor has assumed a loan to the obligor on the account receivable and the discount earned by the factor is functionally the equivalent of interest. By structuring the transaction as the factoring of a receivable rather than as a loan, however, the parties could significantly alter the tax consequences of the transaction and, in particular, could plan around anti-abuse rules of prior law." (General Explanation at 365.)

There are very few products, if any, where U.S. manufacturers are not facing stiff competition as to quality and price from foreign manufacturers. Thus, providing favorable financing rates helps U.S. companies compete with overseas manufacturers. This is true regardless whether export financing is being provided to facilitate the sale of related persons' goods, or the export of goods made by other U.S. companies.

The ability to defer U.S. tax on export financing interest until the income in repatriated has in the past permitted U.S. companies to establish foreign banks to provide export financing at a rate competitive with foreign overseas competitors. The 1984 legislation and the 1986 legislation has totally eliminated the ability of foreign banks owned by U.S. companies to provide favorable export financing. Thus, while concern is generally expressed over the U.S. balance of trade and the impact of the U.S. tax laws on exports, during the past two years amendments have been made to the tax law which totally hinders the ability of U.S. companies to provide competitive export financing.

RECOMMENDATIONS

In order to assist U.S. companies in the export of U.S.-made goods, it is recommended that the export financing exception for foreign banks be amended so that it applies to interest from the export financing of inventory product produced in the United States by related and unrelated persons.

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July 14, 1987

Robert J. Leonard, Esq.
Chief Counsel
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Dear Rob:

The following comments are submitted for consideration by the Committee on Ways and Means with respect to H.R. 2636, the Technical Corrections Bill of 1987 as introduced. These comments suggest that section 864(e) of the Internal Revenue Code of 1986, which was added to the Code by section 1215(a) of the Tax Reform Act of 1986 and deals with the allocation of interest expense, be modified as set forth in the attached proposed amendment.

The legislative history to the 1986 Act indicates that section 864(e) was enacted because Congress believed that the separate company allocation rules of prior law were inconsistent with the policy underlying Reg. § 1.861-8(e)(2)(i) "that money is fungible and . . . management has a great deal of flexibility as to the source and use of funds" within an affiliated group. Nevertheless, Congress recognized this policy should be applied separately to certain taxpayers and excepted through section 864(e)(5) financial institutions that (i) are banks or S&Ls, (ii) conduct their business predominantly with persons other than related persons or their customers and (iii) are required by state or federal law to be operated separately from their non-finance affiliates.

Section 864(e)(5) is based on the fact that financial institutions are normally more highly leveraged than other corporations and that their operations are normally financed separately from that of any non-finance affiliates. The separate financing reflects the fact that financial institutions normally have higher credit ratings than their non-finance affiliates notwithstanding their higher leverage. Although these factors demonstrate the correctness of the exception, they also demonstrate that the policy goals of section 864(e)(5) are not fully addressed because other highly leveraged financial institutions that are not banks and S&Ls are not included in the exception.

In enacting section 864(e), Congress also recognized that "proper rules governing the allocation and apportionment of expenses are essential to the proper functioning of the foreign tax credit limitation." Staff of Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 943 (Comm. Print 1987) (the "Blue Book"). Through section 864(e) and the new separate foreign tax credit limitations for certain types of income, Congress sought to minimize the potential abuse by taxpayers of the foreign tax credit provisions of the Code.

Financial services income is one of the types of income for which Congress provided a new separate foreign tax credit limitation. Under section 904(d)(2)(C)(ii)(I) as redrafted by the Technical Corrections Bill as introduced, financial services income means income which is received or accrued by any person predominantly engaged in the active conduct of a banking, financing or similar business. Although section 904(d)(2)(C) is silent as to what threshold is necessary to satisfy the "predominantly engaged in" test, the Conference Report and the Blue Book indicate that a high percentage of a financial institution's income must be attributable to financial services activities in order to meet that test.

Given the definition of financial services income, and the fact that traditional highly leveraged financial institutions earn predominantly financial services income, the policy goals of section 864(e)(5)(C) could be addressed in a more generic manner by modifying that section to contain a cross-reference to that definition. By cross-referencing to section 904(d)(2)(C)(ii)(I), the attached proposed amendment would appropriately give effect to the policy underlying section 864(e)(5) by excepting all similarly situated financial institutions including finance companies to which fungibility of money principles also should be applied separately. Modifying section 864(e)(5)(C) so as to include traditional finance companies is also appropriate because such finance companies provide the same types of services and products as, and compete directly in the financial services market with, banks and S&Ls.

By cross-referencing to section 904(d)(2)(C)(ii)(I), clause (i) of the attached proposed amendment would incorporate the concept of financial services income into section 864(e)(5)(C). This generic approach to clause (i) would give effect to the policy underlying section 864(e)(5) by excepting from the new allocation rules not only banks and S&Ls but also highly leveraged finance companies to which fungibility of money principles should be applied separately.

Clause (ii) of the proposed amendment, which requires that the business of qualifying financial institutions be conducted predominantly with unrelated parties, is carried over without change from current law. This requirement is based on the principle that transactions involving financial institutions whose primary purpose is to serve unrelated borrowers are far less likely to be the subject of tax-motivated manipulation than transactions between two related parties. We believe that this is a sound principle that should remain embodied in section 864(e)(5)(C).

Because finance companies generally obtain the money they lend to the public from a parent company in which all the borrowing activities of the group are centralized (in order to maximize the group's credit rating), while all the lending is done at the subsidiary level to unrelated borrowers, the legislative history should indicate that the Treasury regulations will provide that whether a financial institution meets the requirements of clause (i) and clause (ii) should be determined on a look-through basis.

The proposed amendment to clause (iii) would clarify the separate operation requirement to ensure that all these similarly situated financial institutions may come within section 864(e)(5)(C) as generically rewritten by new clause (i). It would be appropriate for the legislative history to provide that the requirements of clause (iii) will be met by a financial institution that (1) is required by law to be operated separately, (2) is in fact operated separately and issues debt with a separate credit rating that is not guaranteed by any affiliates that did not meet the requirements of clause (i), or (3) complies with such other requirements as may be prescribed by the Treasury Department.

An additional appropriate result of the proposed amendment would be the matching of a qualifying financial institution's financial services interest expense with the income it helps produce. This is a desirable result that is consistent with the general rule of Reg. § 1.861-8(a)(2) that "allocations and apportionments [be] made on the basis of the factual relationship of deductions to gross income."

I hope that the above information proves helpful. If you have any questions about these comments please do not hesitate to contact me.

Sincerely,

John J. Salmon

Attachment

July 14, 1987

[Sec. 864(e)(5)]

(C) DESCRIPTION.--A corporation is described in this subparagraph if--

(i) such corporation is a financial institution predominantly engaged in the conduct of a banking, financing, or similar business within the meaning of section 904(d)(2)(C)(ii)(I),

(ii) the business of such financial institution is predominantly with persons other than related persons (within the meaning of subsection (d)(4)) or their customers, and

(iii) such financial institution is operated separately from any other entity which is not such an institution.

Section 1221

David M. Farmer
Vice President — Federal Affairs

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July 16, 1987

Mr. Robert J. Leonard
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1111 Longworth House Office Building
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Re: Technical Corrections Bill - H.R. 2636 - S. 1350
Related Person Insurance Income - Election

Dear Mr. Leonard:

The Alliance of American Insurers believes that Section 112(h)(1) of H.R. 2636 misconstrues the intent of Congress with respect to the election provided in section 953(c)(3)(C) of the Internal Revenue Code. The Alliance is a trade association of over 175 property/casualty insurance companies that do business in all 50 states and the District of Columbia. We urge that section 112(h)(1) be revised to provide that this election is available with respect to U.S. shareholders to whom subpart F income is attributed solely because of the revisions to section 953 in the 1986 Tax Reform Act.

The 1986 Act expanded the definition of "U.S. shareholder" with respect to offshore insurance companies to include any U.S. person owning any stock in an offshore insurer (or, in the case of mutual companies, any U.S. policyholder with the right to vote). The definition of "controlled foreign corporation" ("CFC") was also revised so that, if such an offshore insurer is 25% or more owned by U.S. shareholders, subpart F income is attributed to such shareholders in the taxable year in which it is earned by the company. In section 953(c)(3)(C), Congress provided an election to mitigate the harshness of this rule. If the offshore insurer elects to treat all of its insurance income as effectively connected with a U.S. business, it is taxed as though that income was U.S. income and subpart F income is not attributed to the U.S. shareholders. There is no requirement in the 1986 Act or the conference report on H.R. 3636 that the offshore insurer must not be a CFC without application of the 1986 Act's provisions in order to be eligible for this election.

Section 112(h)(1) of H.R. 2636 would deny this election to an offshore insurer that was or becomes in the future a CFC under the rules prior to the 1986 Act. The Joint Committee on Taxation's staff explained that this provision is

> "to make it clear that the election is not available to a corporation that is a controlled foreign corporation without applying the special subpart F rules for captive insurance companies... Thus, the bill clarifies that the election is available only in situations where a foreign corporation *and its shareholders* are subject to subpart F treatment by *virtue of the Act's* special captive insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context." *Description of the Technical Corrections Act of 1986*, *Joint Committee on Taxation, June 15, 1987, pp. 198-199* (emphasis added).

It would appear that Congress intended to allow the election with respect to shareholders who would not be subject to subpart F treatment under prior law, while denying it to those who would be subject to subpart F.

Unfortunately, section 112(h)(1) does not conform to this intent in the case where an offshore insurer was a CFC under pre-1986 Act rules but most of the U.S. participants were not "U.S. shareholders" subject to subpart F attribution. For instance, at least one U.S. insurer has arranged for the establishment of an offshore mutual insurance company. This U.S. insurer holds reserve certificates that entitle it to 40% of the voting power of the offshore company, with the remaining 60% divided among the offshore company's policyholders, which are U.S. persons but who were not "U.S. shareholders" under the old rules. Subpart F income was and is attributed to the U.S. insurer, which has always been a "U.S. shareholder". Under the 1986 Act, however, the U.S. policyholders also become "U.S. shareholders", and subpart F income is attributed to them as well. Since, as the Joint Committee staff stated, it was the intent of Congress to provide the section 953(c)(3)(C) election to shareholders of a foreign corporation who were not subject to the subpart F rules under prior law, we believe that election ought to be available with respect to those U.S. shareholders.

We believe that section 112(h)(1)(A) should be deleted and replaced with the following language:

> "Any election under this subparagraph shall not apply to related person insurance income which (determined without reference to this subsection) constitutes insurance income includable in the gross income of one or more United States shareholders under sections 951(a)(1)(A)(i) and 952(a)(1)."

This language denies the benefit of the election to any person to whom subpart F income was attributed before the 1986 Act revisions (including the U.S. insurer in the example above), while providing the election with respect to persons who would not be U.S. shareholders without the application of the 1986 Act. Section 112(h)(1)(B) of H.R. 2636 would then be unnecessary, and should also be deleted.

We believe that these changes are non-controversial clarifications of the Congress' intent, and we urge their adoption in H.R. 2636 and S. 1350.

Sincerely,

Stephen W. Broadie
Senior Counsel - Taxation and Finance

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July 10, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Dear Rob:

In accordance with the Chairman's announcement June 10 accompanying the introduction of H.R. 2636, we submit the following comments on behalf of The Continental Corporation and The Chubb Corporation concerning the Technical Corrections Act of 1987.

Our comments are confined to the foreign tax provisions in Part XII of the bill, specifically Part C, U.S. Taxation of Income Earned Through Foreign Corporations, and more particularly U.S. taxation of income earned by a bona fide foreign insurance affiliate located in a high tax nation.

REAFFIRMATION OF INSURANCE TAX REFORMS

From the earliest proposals until final passage of the Tax Reform Act of 1986, we encouraged reform of U.S. insurance taxation. Removal of tax shelter opportunities from property-casualty insurance will result in more stability and availability for American consumers.

Bona fide property-casualty insurance companies are unique taxpayers. The Treasury, the Internal Revenue Service and the federal courts have long distinguished legitimate property-casualty insurance companies from other taxpayers on the basis of risk shifting and distribution. A bona fide property-casualty insurer is permitted for federal income tax purposes to use accounting methods denied other taxpayers because the unrelated insured transfers all risk to the insurer, and the insurer in turn distributes the assumed risk over a wide variety of policyholders. See Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Rev. Rul. 77-316, 1977-2 C.B. 53.

Property-casualty insurance investment income is not "passive interest-type income" separate and apart from basic insurance operations. Investment income is integral to the ability of an insurer to pay claims. It is considered in pricing the policy. The insurer's cost of fulfilling its obligation to policyholders is never fully funded through premium payments.

Congress has recognized consistently that taxable income of a property-casualty insurer reflects aggregate underwriting and investment results. The 1986 reforms seek to measure property-casualty taxable income more accurately under the fundamental premise that insurance income is a function of combined underwriting and investment results. The integrity of this system must be preserved. Neither the Treasury, nor consumers, nor bona fide insurance underwriters benefit when the basic tenets of insurance taxation are abused or transferred for tax shelter purposes.

CONGRESS INTENDED FOR A HIGH TAX EXCEPTION TO BE AVAILABLE FOR BONA FIDE AMERICAN INSURERS.

Under the 1986 Subpart F revisions virtually all insurance income of a foreign insurance affiliate is attributed back to the American insurance parent and taxed currently. Imputed income is calculated under Subchapter L as if the foreign insurance affiliate were a U.S. insurance company. By revising Subpart F, Congress wanted to end the practice of using tax haven or low tax countries to shield U.S. income from U.S. tax. At the same time Congress intended to protect the operations of bona fide U.S. companies in high tax nations. Congress believed that Subpart F would "impose current tax only on income of controlled foreign . . . insurance companies that is in fact received in low-tax jurisdictions."[1]

Congress enacted Section 954(b)(4)[2] to shield companies operating in high tax countries from current tax. On its face Section 954(b)(4) appears to work. However, the unforeseen interplay between new Subpart F foreign insurance reforms, new Subchapter L domestic insurance reforms, and existing foreign insurance tax systems takes away the Section 954(b)(4) exception Congress thought it had provided for American insurers with bona fide foreign affiliates in high tax nations.

SECTION 954(b)(4) DOES NOT WORK

The 954(b)(4) exception does not work for a U.S. foreign insurance affiliate because the new U.S. insurance tax base is now fundamentally different from any foreign insurance tax base. Before 1986 all major trading nations, including the U.S., based taxation of property-casualty insurers on regulatory accounting.

The new U.S. system now discounts premium reserves and taxes a portion of tax-exempt investment income. At the same time the new U.S. system accelerates recognition of premium income. In effect income is increased and deductions are decreased, resulting in a higher tax base.

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[1] H. Rep. No. 426, 99th Cong., 1st. Sess. pgs. 398-399 (emphasis added).

[2] I.R.C. § 954(b)(4) provides an exception for companies operating in a high tax country. Under Section 954(b)(4) Subpart F income does not include income that was subject to an effective rate of tax in the foreign jurisdiction greater than 90 percent of the U.S. tax rate.

Other major trading nations adhere to traditional property-casualty taxation. Consequently, the 954(b)(4) exception will never work for any U.S. property casualty insurance company--even those operating in jurisdictions with statutory tax rates *higher* than the U.S. rate.

THE "SAME-COUNTRY" EXCEPTION DOES NOT WORK

Section 953 provides an exception for income from insuring unrelated risks within the country in which the foreign insurance affiliate is incorporated. This approach does not recognize the global nature of property-casualty insurance. The business of international insurance is not confined to one country. In order to compete, U.S. insurers must cover multinational insureds around the world. It is necessary to write international coverage out of a country such as England to cover non-English risks due to the network of tax and trade barriers other nations erect against U.S. insurers. The London market is also the leading source for underwriting international risks from all over the world. "Same-country" risks are a minuscule portion of the insurance underwritten in London. The "same-country exception" does not recognize the business realities of the international insurance market.

PUNITIVE TAX IMPACT

Two examples illustrate the punitive tax impact and competitive disadvantage that result from the failure of U.S. foreign affiliates to qualify for the 954(b)(4) exception. The examples are based on 1986 actual operating results of 100% owned foreign affiliates of a leading U.S. property-casualty insurer.[3]

1. Nondomiciled Risks

Company A is organized in the United Kingdom (U.K.) and writes international reinsurance in conjunction with the Lloyd's market in London. It writes no U.K. risks. Lloyd's is the largest single market in the world for international commercial coverage. Company A's entire taxable income from both underwriting and investments, as measured under the new Subchapter L for U.S. property-casualty insurers, will be currently taxed to its U.S. parent. As a result, this *bona fide* U.K. affiliate will generate a U.S. tax liability of between $5.3 and $5.5 million to its U.S. parent even though U.K. taxes paid by that subsidiary were only $300,000. Any non-U.S. owned insurer of international risks in the London market would pay only $300,000 in worldwide tax on identical operating results.

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[3] For some of these companies, no foreign tax credit ("FTC") is available because the foreign insurance affiliate is more than a third-tier subsidiary. *See* § 960(a). For other companies, the FTC is available. Consequently, each example will show the additional U.S. tax burden assuming first full creditability and then zero creditability.

2. Domiciled Risks

Even where same-country underwriting income will not be taxable to the U.S. parent, insurance investment income remains subject to current taxation. For most property-casualty companies, investment income is the only source of profits. Underwriting income is almost always negative.

Company B is a Canadian subsidiary. When the tax base for the Canadian affiliate is recalculated under new Subpart F, the U.S. parent will incur from $700,000 to $2.0 million of U.S. tax in addition to the $2.05 million of Canadian tax incurred by Company B. Any non-U.S. owned Canadian insurer will not pay the additional $2.05 million. This result occurs under Subpart F even though the Canadian statutory rate exceeds 50 percent.

TRANSITION RULE

Section 1221(g)(3) of the Tax Reform Act of 1986, as modified by the Technical Corrections Act of 1987, grants the two largest American international insurers relief from the full impact of all foreign insurance tax reforms in Subpart F during the first three years the law is effective. Clearly transitional relief is appropriate. It is difficult to understand, however, why relief is given to the largest American international insurers, but a technical correction is not included to make the high rate exception work for the third and fourth largest American international insurers. The smaller companies will bear the full burden of paying new Subpart F taxes during the first three years the law is effective.

A TECHNICAL CORRECTION IS REQUIRED

In order to make the 954(b)(4) exception available for bona fide foreign insurance affiliates a technical correction is required. The technical correction would be available only to bona fide foreign insurance affiliates operating in high insurance tax nations. The technical correction would provide for a three year transition period. After three years the Secretary of the Treasury would be granted authority to designate high insurance tax nations using narrowly defined criteria that will adjust for differences as they change in new U.S. insurance tax law and existing foreign insurance tax law. The correction will only apply to qualified bona fide insurance companies operating in high insurance tax nations. An anti-avoidance provision will be included. If other high tax nations adopt insurance tax reforms, the Secretary will be able to reflect this in the list of designated nations. Canada is now exploring reform of its insurance tax laws.

U.S. TAX POLICY FAVORS FOREIGN INSURERS OVER AMERICAN INSURERS

American foreign insurance affiliates must compete for overseas business with established foreign companies. Foreign insurers are taxed only on foreign tax bases which rest upon regulatory accounting principles. Only the new U.S. property-casualty reforms depart significantly from regulatory accounting principles in measuring taxable income.

The competitive problem arises overseas from applying the new U.S. domestic insurance reforms to foreign affiliates of American insurers which compete against foreign insurers taxed under regulatory accounting systems. As a result some American foreign affiliates in critical markets will pay taxes 1,800% higher than any competitor.

Inside the United States, the Treasury is willing to tax foreign insurers for U.S. tax purposes on their own foreign tax base. We have no objection to that. What is objectionable, however, is the U.S. Government's refusal to recognize vast differences in foreign high tax bases for American insurance affiliates competing overseas.

IMPORTANT FOREIGN MARKETS FOR AMERICAN INSURANCE WILL BE LOST. MANY SUPPORT STAFF JOBS WILL BE ELIMINATED INSIDE THE U.S.

A few American insurers compete in the global market against major foreign insurers domiciled in the United Kingdom, Germany, France, Italy, Japan, Switzerland, the Netherlands, and Canada. Worldwide insurance premium volume in 1984 was $498 billion dollars. Of this amount 56.5 percent was property-casualty business. The major commercial centers are the European Economic Community with $56.9 billion in property-casualty premiums; the rest of Europe, with $11.45 billion; Japan, $21.8 billion; and Canada, $8.6 billion.

Chubb and Continental have been active in international insurance markets for years. Their bona fide foreign operations are not newly hatched tax haven schemes. International operations create new jobs inside the United States. Lead underwriters and technical support staffs are located in the United States. A fully computerized global network allows Americans to provide risk analysis, status reports or other information about complex multinational risks to field staffs overseas.

International insurance has grown as rapidly as 80% during the past five years. Approximately 3,000 Chubb and Continental employees support foreign operations. New employees have been hired to support this growth. If the 954(b)(4) exception is not available, affiliates in high tax nations will be sold, resulting in a loss of 750 jobs within the United States. More important than the loss of current jobs is the removal of future economic growth for American insurers which will benefit our entire economy.

If the excessive taxation of American insurers' bona fide foreign affiliate income from high tax nations is not reversed, international insurance premiums will be lost to foreign competitors. The Harvard Business Review noted recently that U.S. service industries, including insurance, could follow American manufacturing into decline. Net positive trade balances in services have fallen steadily since the beginning of the decade -- from $41 billion in 1981 to $21.4 billion in 1985. See James B. Quinn and Christopher E. Gagrion, "Will services follow manufacturing into decline?" Harvard Business Review, Nov-Dec. 1986.

THE TECHNICAL CORRECTION IS IN ACCORD WITH GATT AND OTHER U.S. LAWS.

The General Agreement on Tariffs and Trade ("GATT") is designed to keep nations from pursuing national trade policies harmful to other nations and the world economy as a whole. The "Most-Favored-Nation" and "National Treatment on Internal Taxation and Regulation" clauses aim at breaking down trade barriers.

The technical correction would create no barriers to trade nor give U.S. companies any advantage not extended to foreign insurers. The technical correction would merely put American insurers in a competitive position with foreign insurers in foreign markets. This is in accordance with GATT goals. The U.S. already accords foreign insurers a more favorable tax status inside the U.S. than it provides for American insurers.

The fact the technical correction names specific countries for its purposes does not violate GATT. So long as the purposes of the GATT agreements are effectuated a nation may adopt its laws in any form it chooses.

Other provisions of the Internal Revenue Code list countries by name. Section 1201(e)(2)(H) of the Tax Reform Act defines "qualified loans" for the foreign tax credit as loans made to one of thirty-three specified countries or the residents thereof. I.R.C. § 999 requires the IRS to issue a list of countries that may require participation in, or cooperation with an international boycott. See also Notice 87-40, 1987-23 I.R.B. 13. (list of § 999 countries). The proposed technical correction would be in accordance with GATT and would follow a well-established format in the Internal Revenue Code.

NO REVENUE IMPACT

Congress enacted the high effective rate exception in Section 954(b)(4) with the intent that American businesses conducting bona fide operations in high tax nations would not be subject to Subpart F reforms designed to raise revenue from operations in tax haven or low tax nations. No revenue was intended to be raised under Section 954(b)(4).

The data used by the Joint Committee to estimate revenue under Subchapter L and under Subpart F from American insurers did not include income from foreign insurance affiliates in high tax nations. Consequently a technical correction will have no negative impact upon insurance revenue estimates provided Congress under the Tax Reform Act of 1986.

If the Section 954(b)(4) exception continues to be unavailable for American insurers, and if American insurers continue to operate their affiliates in high tax nations as they now do, less than $50 million in revenue will be collected.

Without the Section 954(b)(4) exception, bona fide foreign affiliates will be subject to a tax increase of 1,800%. No other foreign or domestic competitors will be so affected. Competition under such a punitive tax structure will be impossible. The result will be outright sales of bona fide foreign affiliates of American insurers in high tax nations to foreign insurers. The source of all future income will no longer be owned by Americans.

We would be pleased to provide the Committee with any additional information which would be helpful.

Sincerely yours,

Walter Vinyard

Walter D. Vinyard, Jr.

July 10, 1987

STATEMENT OF
OVERSEAS SHIPHOLDING GROUP, INC.
TO THE COMMITTEE ON WAYS AND MEANS

Re: Proposed Technical Corrections to Provisions Taxing Previously Excluded Shipping Income of U.S. Controlled Foreign Corporations

This statement and the attached memorandum are submitted on behalf of Overseas Shipholding Group, Inc. ("OSG") for inclusion in the record of private sector comments on H.R. 2636, the proposed Technical Corrections Act of 1987. OSG is a U.S. corporation which, directly and through various subsidiaries and affiliates, is engaged in the ocean transportation of liquid and dry bulk cargoes in both the worldwide and U.S. markets. Certain of OSG's shipping subsidiaries are controlled foreign corporations ("CFCs"), thus making OSG subject to taxation under Subpart F of the Internal Revenue Code (the "Code") with respect to the income of these subsidiaries.

1986 Repeal of the Reinvestment Exclusion

In section 1221(c) of the Tax Reform Act of 1986 (the "1986 Act"), Congress repealed the reinvestment exclusion for foreign shipping income of a CFC, effective for taxable years beginning after December 31, 1986. As a result, the U.S. shareholders of a CFC will be taxed currently on all post-1986 earnings derived from the CFC's foreign shipping operations.

In making this change, Congress intended to tax current shipping income on a prospective basis. However, because Congress failed to modify the rules governing the taxation of withdrawals of investment in shipping (particularly those which occur only by virtue of a required adjustment to the basis of depreciable assets), a CFC's U.S. shareholders may be subject to taxation even on pre-1987 earnings, a presumably unintended result. This increased exposure to tax with respect to prior earnings, in combination with full taxation of current earnings, will make it extremely difficult for U.S. shippers to compete with foreign-owned operations, thus threatening the viability of the U.S.-controlled foreign fleet.

The Denial of Depreciation Deductions

While the proposed legislation (H.R. 2636) properly addresses a technical flaw in the 1986 Act's formula for calculating investment decreases (by ensuring that withdrawals of previously excluded Subpart F income from qualified shipping reinvestments are taxed only once), it fails to incorporate a more fundamental change that is needed to prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 earnings. Under section 955 of the Code, CFCs will still be required to actually increase investments abroad just to avoid generating current tax liabilities on amounts reinvested in depreciable shipping assets in prior years. This perverse result occurs because, under current law, the amount of investment attributable to "property" is determined by the property's "adjusted basis." See section 955(b)(4) and Treas. Reg. § 1.955A-2(g)(1). Thus, a CFC which maintains, but does not increase its fleet, will be subject to tax on the amount by which the basis of its property is adjusted for depreciation each year.

A simple example illustrates the impact of depreciation in the calculation of investment decreases. Assume that under prior law, a CFC has previously deferred $50,000 in earnings by reinvesting such earnings in shipping. At the close of its 1986 tax year, it owns a single ship that has an adjusted basis of $50,000. The ship generates yearly depreciation deductions equal to $5,000. Thus, in each succeeding taxable year, the adjusted basis of the CFC's ship will decline by $5,000. As a result of the required adjustment to the basis of its asset, and assuming the CFC makes no new investments, the U.S. shareholder of the CFC will have to recognize an additional $5,000 in income each year until the ship is fully depreciated. In effect, taxpayers who hold depreciable shipping assets are denied the benefit of depreciation deductions, since the amounts deducted as depreciation will trigger immediate recapture of a corresponding amount of previously deferred income.

Proposed Technical Amendment to Section 955

In order to prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 tax deferred earnings, section 955 should be amended to (1) exclude post-1986 depreciation allowances on assets placed in service in foreign base company shipping operations on or before December 31, 1986 from the calculation of investment decreases and (2) limit the continued exclusion attributable to such depreciation allowances to make it progressively unavailable to companies that derive less than 65% of their gross receipts from shipping. In addition, to the extent that previously excluded earnings continue to have the benefit of tax deferral, all such amounts should be subject to tax upon repatriation to the CFC's U.S. shareholders.

The exclusion of post-1986 depreciation allowances from the calculation required under section 955 could be accomplished by providing that if a decrease in the level of qualified investment occurs after December 31, 1986, such decrease shall be taken into account under section 955 only to the extent that it exceeds the "Accumulated Depreciation Amount." The "Accumulated Depreciation Amount" would be defined as the cumulative amount of depreciation allowed or allowable in taxable years beginning after December 31, 1986 (up to and including the present taxable year) with respect to assets placed in service in foreign base company shipping operations before that date.

In order to discourage shipping companies from allowing their fleet to depreciate simply as a prelude to liquidating their shipping operations, continued deferral of tax on the Accumulated Depreciation Amount would be fully available only to a CFC which is a "qualified shipping company." For any taxable year, a "qualified shipping company" would be defined as a CFC that derives an average of not less than 65% of its gross receipts over the immediately preceding three-year period from foreign base company shipping activities. As explained more fully in the attached memorandum (which has previously been provided to the staff of the Committee), if a CFC failed to meet the 65% test, then a portion of the accumulated depreciation amount would be taken into income in the relevant year.

A simple example illustrates the mechanics of the proposed amendment. At the close of its 1986 taxable year, a CFC has qualified investments consisting of one ship with an adjusted basis of $120, and previously deferred earnings of $100. In the next three taxable years (calendar years 1987-1989), the CFC takes depreciation allowances of $20 per year. Thus, the ship's adjusted basis declines by a total of $60. Under the 1986 Act, this decline in basis would normally trigger the inclusion in income of a corresponding amount of previously deferred earnings. Under the proposed amendment, no such inclusion in income would result so long as the CFC meets the "65% test" and thus is a "qualified shipping company."

Suppose, however, that the CFC began to diversify its income-producing activities and that in 1988, it derives less than 65% (using the three-year averaging method) of its gross receipts from shipping. Consequently, a statutorily determined percentage of its 1988 Accumulated Depreciation Amount of $40 would be recaptured in that year, thereby forcing the inclusion in income of a proportionate amount of previously deferred earnings.

Rationale for the Proposed Amendment

There are several reasons why the proposed amendment should be adopted. First, the amendment to section 955 is necessary to counter the liquidation incentive inherent in the repeal of the reinvestment exclusion. Predictably, the 1986 Act will result in a phasing out of U.S. participation in international shipping. This is the consequence of combining the new law's repeal of the reinvestment exclusion for current earnings with its requirement that previously deferred earnings be included in income when investment in international shipping declines below 1986 levels.

Suppose that we consider separately these two aspects of the new law, starting with the impact of current taxation of CFC shipping income. Taxation of shipping income on a current basis under the 1986 Act tilts the playing field against U.S. companies, because their foreign competitors generally are free from any comparable tax burdens. This is not a viable position for U.S. operators in the highly competitive international shipping market. The lower cash flow resulting from their new tax burden and associated impairment of competitive position will reduce both their incentive and ability to reinvest. Thus, the taxation of current earnings will make it difficult for CFCs to make the new investments needed simply to maintain the existing level of their international shipping assets in the face of normal depreciation. However, unless CFCs make such fresh investments, they will become subject to tax not only on their current earnings, but also on tax-deferred earnings from prior years.

As U.S.-controlled shipping companies experience the joint effects of paying taxes on current as well as prior years' income, the U.S. shareholders of a CFC will be under strong pressure to cause the CFC to liquidate its shipping assets. This may be the only feasible way of raising the necessary cash since, to obtain deferral in the first place, the CFC had to invest substantially all prior income in shipping assets, most of which are non-liquid in nature. Moreover, to the extent that shipping assets are liquidated to pay current taxes, further tax liabilities will arise under the disinvestment provisions. In short, retention of the disinvestment penalty in the absence of the reinvestment exclusion will create a "vicious circle", which may ultimately drive U.S.-controlled operations into complete liquidation.

Second, the proposed amendment is necessary to avoid disparate treatment in the taxation of current income where one CFC had substantial income in pre-1987 years while another CFC had losses (or no net income) in those years. In such cases, the CFC which has been profitable will lose the benefit of current depreciation in the absence of offsetting fresh investments while the CFC which has not been profitable has no prior deferrals to be "recaptured" as a result of depreciation-induced disinvestment. This produces the result that profitable CFCs are treated less favorably under the 1986 Act than are CFCs with a history of losses. A previously unprofitable CFC (or a new CFC engaged in shipping for the first time) will enjoy the benefit of current depreciation in computing current income no matter what disposition it makes of its current income. We see no tax policy reason why the tax laws should make it more difficult for profitable CFCs to compete with other CFCs, as well as against their international competition.

Third, although depreciation has historically been treated as a reduction in investment under Subpart F, one can question whether the inclusion of depreciation deductions in the measurement of investment decreases is appropriate given the underlying objectives of Subpart F, as amended by the 1986 Act. Subpart F provides for the current taxation of the net earnings of a foreign corporation that are available for distribution as a deemed dividend to the corporation's U.S. shareholders. Since depreciation repesents an allocation of the capital cost of the asset, it must be reflected in determining the amounts available for distribution.

Respectfully submitted,

Donald V. Moorehead

Donald V. Moorehead
Patton, Boggs & Blow

STATEMENT OF
OVERSEAS SHIPHOLDING GROUP, INC.

EXHIBIT I

February 3, 1987

MEMORANDUM

Re: Proposed Technical Corrections to Provisions Taxing Previously Excluded Shipping Income of Controlled Foreign Corporations

The Tax Reform Act of 1986 (the "1986 Act") repeals the reinvestment exclusion for foreign shipping income of a controlled foreign corporation ("CFC"). As a result, the U.S. shareholders of a CFC will be taxed currently on all post-1986 earnings derived from the corporation's foreign shipping operations. At the same time, the 1986 Act provides no relief from those provisions of prior law which imposed current taxation on the CFC's shareholders to the extent of any decrease in the corporation's year to year level of investment in shipping operations. This memorandum describes the harsh, and presumably unintended, consequences of this new combination of tax provisions on the shipping industry, and it explains how these provisions threaten the viability of U.S.-controlled foreign fleet.

To mitigate this threat, the forthcoming technical corrections legislation to the 1986 Act should include provisions to (1) prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 tax deferred earnings and (2) clarify the formula for calculating investment decreases to assure that any such decreases are not counted twice. Neither of these proposed corrections will operate to forgive tax on previously deferred earnings or permit the tax-free repatriation of such earnings to the CFC's U.S. shareholders.

I.

Present Law as Amended by the 1986 Act

As a general rule, a foreign corporation is subject to U.S. tax only with respect to income it derives from U.S. sources or from a U.S. trade or business. Thus, a foreign corporation which conducts only foreign operations is not generally subject to U.S. tax. The U.S. shareholders of a foreign corporation are generally subject to U.S. tax on the foreign corporation's income only when such income is distributed to them.

An important exception to these fundamental principles of international taxation is contained in sections 951-964 of the Internal Revenue Code (the "Code"). Under these provisions, certain U.S. shareholders of a CFC are taxed currently on specified categories of the CFC's income ("subpart F income") whether or not such income is currently, or ever, distributed to them. When the subpart F provisions of the Code were originally enacted in 1962, foreign shipping income was not included in the definition of subpart F income. In the Tax Reduction Act of 1975, Congress included such income (as defined in section 954(f) of the Code) in the definition of subpart F income, but only to the extent that the amount of such shipping income earned by a CFC in any taxable year exceeds the increase of the CFC's qualified investments in foreign base shipping company operations. See sections 954(b)(2), 954(g) and 955(b) of the Code. Income previously deferred under such provisions must be taken into income by the U.S. shareholders of a CFC in any subsequent taxable year in which the CFC reduces its qualified investments in foreign base shipping company operations. See sections 951(a)(1)(A)(iii) and 955(a) of the Code.

The 1986 Act repealed the exclusion of reinvested foreign shipping income of a CFC, effective for taxable years beginning after December 31, 1986. See section 1221(c) of the 1986 Act. Thus, foreign shipping income of a CFC henceforth will be currently taxable to U.S. shareholders of a CFC as subpart F income, whether or not such income is reinvested in foreign base shipping assets.

The 1986 Act did not repeal, however, the provision that treats any decrease in investment in shipping assets as a constructive dividend. See sections 951(a)(1)(A) and 955 of the Code. Rather, the 1986 Act merely amended section 955 of the Code so that any subsequent decrease in investment in shipping assets will be measured against the level of such investment as of the close of the CFC's last taxable year beginning before 1987. Thus, to the extent a CFC decreases its investment level below that of December 31, 1986 in any subsequent taxable year, income reinvested in shipping in prior years will become subject to subpart F taxation. While forceful arguments could be made for the simple repeal of the disinvestment provisions (sections 951(a)(1)(A) and 955), even if such provisions are retained, there are at least two significant problems with their treatment of investment decreases.

First, under section 955, CFCs will still be required to actually increase investments abroad just to avoid generating current tax liabilities on amounts reinvested in depreciable shipping assets in prior years. This perverse result occurs because, under current law, the amount of investment attributable to "property" is determined by the property's "adjusted basis." See section 955(b)(4) and Treas. Reg. § 1.955A-2(g)(1). Thus, a CFC which maintains, but does not increase its fleet, will be subject to tax on the amount by which the basis of its property is adjusted for depreciation each year. A simple example will illustrate. At the close of its 1986 tax year, a CFC owns a single ship that has an adjusted basis of $50,000. The ship generates yearly depreciation deductions equal to $5,000. Thus, in each succeeding taxable year, the adjusted basis of the CFC's ship will decline by $5,000. As a result, and assuming the CFC makes no new investments, the shareholder of the CFC will have to recognize an additional $5,000 in income each year until the ship is fully depreciated. In effect, taxpayers who hold depreciable shipping assets are denied the benefit of depreciation deductions, since such amounts will trigger immediate recapture of previously deferred income.

The second problem concerns the calculation of investment decreases. Section 955(a)(2) as amended by section 1221(c) of the 1986 Act, appears to contain a technical flaw. That section states in pertinent part:

> (2) Decrease in qualified investments. For the purposes of paragraph (1) (defining "subpart F income withdrawn from shipping operations") the amount of the decrease in qualified investments . . . is that amount by which --
>
> (A) the amount of qualified investments in foreign base company shipping operations of the controlled foreign corporation as of the close of the last taxable year beginning before 1987, exceeds
>
> (B) the amount of qualified investments in foreign base company shipping operations of the controlled foreign corporation at the close of the taxable year.

Read literally, the statute would seem to require the taxpayer to compute the amount of each succeeding year's decrease in investment with reference to its 1986 investment level. Thus, if a calendar year taxpayer with qualified investments at the end of 1986 totalling $100,000 had investments at the end of 1987 of only $90,000, it would have subpart F income in that year of $10,000 attributable to prior years' deferrals Suppose, however, that in 1988, the taxpayer's qualified investment level declined still further to $80,000. Under the statute as drafted, it appears that the taxpayer's decrease for that year would total $20,000, thus resulting in double taxation of the $10,000 of prior years' deferrals already "recaptured" in 1987. This result would not have occurred under old section 955(a)(2) since it calculated decreases on a rolling basis -- i.e., with reference to the amount "as of the close of the preceding taxable year."

II.

Impact of the 1986 Act on U.S.-Controlled Shipping

Predictably, the 1986 Act will result in a phasing out of U.S. participation in international shipping. This is the unintended consequence of combining the new law's repeal of deferral of taxes on current foreign-source income with its requirement that previously deferred taxes be paid when investment in international shipping declines below 1986 levels. Suppose that we consider separately these two aspects of the new law, starting with the impact of current taxation of CFC shipping income. Taxation of such income on a current basis under the 1986 Act tilts the playing field against U.S. companies, because their foreign competitors generally are free from any comparable tax burdens. This is not a viable position for U.S. operators in the highly competitive international shipping market. The lower cash flow resulting from their new tax burden and associated impairment of competitive position will reduce both their incentive and ability to reinvest abroad. Thus, the taxation of current earnings will make it difficult for CFCs to make the new investments needed simply to maintain the existing level of their international shipping assets in the face of normal depreciation.

This difficulty gives rise to the second problem posed by the 1986 Act for such CFCs. As noted above, unless CFCs reinvest abroad, their investments will fall below the 1986 level, simply by virtue of depreciation deductions. The resulting acceleration of current taxation of the tax-deferred income of prior years represents a denial of depreciation. Particularly in view of the new law's disincentive to reinvest, the recapture of the deductible amounts constitutes, in reality, a tax on gross income.

As they experience the joint effects of paying taxes not only on current but also on prior years' income, the U.S. shareholders of a CFC will be under strong pressure to cause the CFC to liquidate its shipping assets. This may be the only feasible way of raising the necessary cash since, to get deferral in the first place, the CFC had to invest substantially all prior income in shipping assets, most of which are non-liquid in nature. Moreover, to the extent that shipping assets are liquidated to pay current taxes, further tax liabilities will arise under the disinvestment provisions. In short, retention of the disinvestment penalty in the absence of the reinvestment exclusion will create an accelerating "vicious circle", which will ultimately drive U.S.-controlled operations into complete liquidation.

This picture of a "vicious circle" drives home the fundamental inequity of the 1986 Act toward shipping companies. U.S. investors were induced by the deferral provisions of prior law to commit hundreds of millions of dollars to their foreign shipping operations. But now, the 1986 Act has changed the rules in a particularly destructive way. It hits U.S.-controlled ships with a "double whammy" of taxes on both current and past income, while their foreign competitors remain unaffected. This situation is critically different from one where all competitors operate under the same or similar tax jurisdictions. There, tax increases affect all more or less equally: their competitive positions change little, if at all. For U.S. owners of foreign flag ships, however, the effects of the 1986 Act are nothing short of confiscatory.

Finally, the Act will require changes in financial reporting which, apart from the tax increases under the 1986 Act themselves, will handicap U.S. operators in raising both equity and debt capital. As a result of the shipowners' inability to continue deferring taxes on their reinvested earnings, U.S. shareholders will in most cases be required to reduce their earnings and net worth (as reported for financial statement purposes under generally accepted accounting principles) to reflect anticipated future taxation of previously deferred income. Formerly, deferred taxes did not have to be "booked" because the reinvestment exclusion provided the mechanism for what amounted to indefinite deferral. But now, with the repeal of that exclusion, most taxpayers will have to report, in a single year, accrued tax liabilities on their accumulated, previously untaxed earnings. The magnitude of these one-time charges could be catastrophic (e.g., resulting in defaults under loan covenants).

III.

The Proposed Technical Corrections

A. Exclusion of Depreciation from Calculation of Investment Decreases

In order to prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 tax deferred earnings and, at the same time, to counter the liquidation incentive inherent in the repeal of the reinvestment exclusion, section 955 should be amended to (1) exclude post-1986 depreciation allowances on assets placed in service in foreign base company shipping operations on or before December 31, 1986 from the calculation of investment decreases and (2) limit the continued exclusion attributable to such depreciation allowances to make it progressively unavailable to companies that derive less than 65% of their gross receipts from shipping. In addition, to the extent that previously excluded earnings continue to have the benefit of tax deferral, all such amounts should be subject to tax upon repatriation to the CFC's U.S. shareholders.

The exclusion of post-1986 depreciation allowances from the calculation required under section 955 could be accomplished by a new subsection providing that if a decrease in the level of qualified investment occurs after December 31, 1986, such decrease shall be taken into account under section 955 only to the extent that it exceeds the "Accumulated Depreciation Amount." The "Accumulated Depreciation Amount" would be defined as the cumulative amount of depreciation allowed or allowable in taxable years beginning after December 31, 1986 (up to and including the present taxable year) with respect to assets placed in service in foreign base company shipping operations before that date.

In order to discourage shipping companies from allowing their fleet to depreciate simply as a prelude to liquidating their shipping operations, continued deferral of tax on the "accumulated depreciation amount" would be fully available only to a CFC which is a "qualified shipping company." For any taxable year, a "qualified shipping company" would be defined as a CFC that derives an average of not less than 65% of its gross receipts over the immediately preceding three-year period from foreign base company shipping activities. If a CFC does not meet the 65% test, then a portion of the accumulated depreciation amount must be taken into income in the relevant year in accordance with the following table:

Shipping Receipts as a Percentage of Gross Receipts	Taxable Portion of Accumulated Depreciation Amount
65% or more	0%
60% to 64.9%	10%
55% to 59.9%	20%
50% to 54.9%	30%
45% to 49.9%	40%
40% to 45.9%	60%
35% to 39.9%	80%
Less than 35%	100%

The amount of previously deferred income subject to tax in any year the "Accumulated Depreciation Amount" rule (i.e., because the taxpayer fails the 65% test), the amount of taxable income recognized in any year should be reduced by an amount equal to the previously deferred income taken into account in prior taxable years beginning after December 31, 1986.

A simple example will illustrate the mechanics of the proposed amendment. At the close of its 1986 taxable year, a CFC has qualified investments consisting of one ship with an adjusted basis $120, and previously deferred earnings of $100. In the next three taxable years (calendar years 1987-1989), the CFC takes depreciation allowances of $20 per year. Thus, the ship's adjusted basis declines by a total of $60. Under the 1986 Act, this decline in basis would normally trigger the inclusion in income of a corresponding amount of previously deferred earnings. Under the proposed amendment, no such inclusion in income would result so long as the CFC meets the "65% test" and thus is a "qualified shipping company."

Suppose, however, that the CFC begins to diversify its income-producing activities and that in 1988, it derives only 57% (using the three-year averaging method) of its gross receipts from shipping. Consequently, 20% of the 1988 Accumulated Depreciation Amount of $40 will be recaptured in that year, thereby forcing the inclusion in income of $8 of previously deferred earnings. Assuming a constant level of depreciation each year ($20 per year) and shipping receipts at a constant 57% of gross, the U.S. shareholders of the CFC will take constant amounts of previously deferred earnings into income in each succeeding year. Of course, the amount of previously deferred income to be taken into account in any year will be increased to the extent that the CFC derives a smaller portion of its gross receipts from shipping.

B. Calculation of Investment Decreases for Post-1986 Taxable Years

The 1986 Act amended section 955(a)(2) so that decreases in qualified investment are calculated off a fixed benchmark amount ("the amount of qualified investments. . . as of the close of the last taxable year beginning before 1987") rather than on a rolling basis. This aspect of the amended definition should be retained but the calculation should be clarified to prevent double-counting of investment decreases in succeeding taxable years. This could be accomplished by adding a sentence at the end of section 955(a)(2) to the effect that any such decrease in investment shall be taken into account only once for purpose of section 951(a)(1)(A).

Donald V. Moorehead
Patton, Boggs & Blow

July 17, 1987

RE: Proposed Section 112(h)(2)(B) of the Technical Corrections Act of 1987 -- Determination of Pro Rata Share under IRC §953(c)

FROM: Sutherland, Asbill & Brennan
Cahill Gordon & Reindel

The purpose of this submission is to urge the deletion of proposed section 112(h)(2)(B) of the Technical Corrections Act of 1987. That section contains a special definition of "pro rata share" which is proposed for purposes of allocating related person insurance income ("RPII") to the U.S. shareholders of captive insurance companies that are subject to section 953(c) of the Internal Revenue Code of 1986 (the "Code"). Subject to a company-wide earnings and profits limitation, the general approach of the special pro rata share rule is to allocate RPII to U.S. shareholders of captive insurance companies as if they were the only shareholders of the company. In fact, of course, the company may also have foreign shareholders and it may earn income that is not RPII by insuring foreign persons or U.S. persons who are not also shareholders.

The proposed new pro rata share rule for allocating RPII is unprecedented under Subpart F of the Code and is inconsistent with tax principles generally. A provision which effects such a basic change in longstanding tax principles can hardly be termed a "technical correction."

Moreover, the proposed rule does not comport with economic reality. The description of the Technical Corrections Act prepared by the Staff of the Joint Committee on Taxation provides a deceptively appealing example of how the proposed pro rata share rule is expected to operate. In the example it was assumed that 50 percent of the stock of a captive insurance company was owned by U.S. shareholders, 50 percent was owned by foreign shareholders, and 50 percent of the company's income was RPII. All of the RPII was allocated to the company's U.S. shareholders under the proposed pro rata share rule, leaving the superficial impression that the U.S. shareholders were entitled to the income which was allocated to them. In fact, however, a special allocation of certain income items to a sub-group of shareholders is inconsistent with an accurate economic view of the respective shareholders' claims to corporate earnings. The U.S. shareholders had no greater claim to RPII than to other corporate earnings.

The flaw in the proposed rule can be illustrated by reference to the rules for the allocation of income earned by a partnership. Taxpayers generally are not allowed to allocate a specific kind of partnership income to particular partners because such allocations lack "substantial economic effect." Treas. Reg. §§ 1.704-1(b)(2)(iii)(a) and 1.704-1(b)(5), ex. 5. The notion that such allocations of partnership income have no economic foundation, and thus should not be given effect for tax purposes, applies equally to allocations of corporate income.

The inequity of the proposed pro rata share rule is highlighted by looking at the case of a U.S. shareholder who is not a policyholder (or related to a policyholder) but under section 953(c) of the Code is nevertheless subject to the captive insurance company provisions. Assume that the U.S. shareholder has a 10 percent interest in a foreign insurance company, 50 percent owned by U.S. shareholders and 50 percent owned by foreign shareholders. If the captive is not a controlled foreign corporation and generates $100 of income, none of which is RPII, the 10 percent U.S. shareholder would have no current Subpart F inclusion. Assuming, on the other hand, that the company earned $100.00, $20.00 of which constituted RPII, the U.S. shareholder would be charged with $4 of Subpart F income under the proposed pro rata share rule, even though his economic share of the RPII, based on his 10 percent interest in the company, would be only $2. The proposed pro rata share rule thus would have a multiplier effect whereby, on these facts, each additional dollar of RPII allocable on an economic basis to the U.S. shareholder would result in the allocation of two dollars of RPII for tax purposes. Stated another way, only one-half of the company's net income would have to be RPII before the U.S. shareholder would be subjected to tax on his entire share of corporate profits. This same inequity would exist for a U.S. shareholder that was also an insured, and thus itself generated RPII, since the U.S. shareholder would be charged with a greater share of the RPII generated by unrelated U.S. shareholders than would be justified by its percentage interest in the company.

U.S. shareholders of controlled foreign corporations that generate other kinds of Subpart F income are not subject to a special allocation rule -- even if the Subpart F income arises from transactions between the corporation and its U.S. shareholders. A controlled foreign corporation might, for example, generate all of its foreign base company sales income or foreign base company services income from transactions with its controlling U.S. shareholder. Presumably recognizing that any profit derived from such transactions must be shared with the company's other shareholders, only a pro rata share of that foreign base company income would be allocated to the controlling U.S. shareholder under Subpart F of the Code. This would be the result notwithstanding other activities in the controlled foreign corporation that generated sufficient additional earnings and profits to support an allocation of all foreign base company income to the controlling U.S. shareholder. In the context of foreign insurance companies, the case for not specially allocating RPII to U.S. shareholders is even more compelling because a U.S. shareholder subject to tax does not even have to own a 10 percent interest in the company.

In summary, the proposed pro rata share provision is neither a "technical correction" nor a sound rule. It should be deleted from the proposed legislation.

Thank you for your consideration of these comments.

SUTHERLAND, ASBILL & BRENNAN

July 17, 1987

Memorandum Re Impact of Amended Section 953(a) of the Code With Respect to the Reinsurance of Risks Located Within U.S. Possessions

The purpose of this memorandum is to highlight a serious problem caused by section 953(a) of the Code, as amended by the Tax Reform Act of 1986 ("the 1986 Act"), and to suggest a possible solution to it.

Limitation of U.S. Tax Deferral to "Same Country Risk" Underwriting Income. Prior to the 1986 Act, underwriting (premium) income earned by a controlled foreign corporation ("CFC") from the insurance or reinsurance of the risks of unrelated persons located anywhere outside the U.S. did not constitute Subpart F income and thus enjoyed U.S. tax deferral until the earnings attributable to such income were actually distributed to the CFC insurer's U.S. shareholders.

The 1986 Act amendments to section 953(a) of the Code rolled back significantly the scope of such deferral, treating as Subpart F income all underwriting income earned by a CFC insurer except to the extent such income is attributable to the insurance or reinsurance of risks located within the same country in which the CFC insurer is organized.

As summarized below, we believe that the foregoing amendments, as applied to the reinsurance of risks located within the Possessions, could produce an unintended and inappropriate, adverse impact on the availability of basic insurance coverage in the Possessions, and on the competitiveness of U.S.-owned commercial reinsurers abroad.

Impact on U.S. Possessions. Insurance companies operating in the U.S. Possessions have for many years expanded their capacity to underwrite policies covering the lives, health, property and liability risks of Possessions residents by reinsuring a portion of their liability with reinsurers incorporated and operating in various jurisdictions outside of the Possessions. As the financial resources and sophistication of individual Possessions residents have increased over the years (due in part to U.S. incentives and assistance), the demand for insurance has increased, as has the reliance of Possessions-based insurers on foreign reinsurers to provide the necessary capacity. The ability of foreign reinsurers to assume such risks, at low enough rates to permit Possessions-based carriers to offer coverages within the financial means of individual Possessions policyholders, was made possible to a material degree through the special tax advantage provided to such reinsurers under pre-1986 Act law.

The foregoing situation has been dramatically altered by the 1986 Act amendments to section 953(a). As a result of those amendments, all of the underwriting income of non-Possessions-based CFC reinsurers from the reinsurance of policies covering risks located within the Possessions is now subject to current U.S. taxation. While it is true that under amended section 953(a) CFC reinsurers incorporated in the Possessions would continue to enjoy U.S. tax deferral in respect of their Possessions-risk underwriting income, as a practical matter in only rare instances is such Possessions-risk reinsurance business substantial enough to make it economically feasible for a CFC reinsurer to relocate (or for a separate CFC reinsurer to be organized) in a Possession, even after taking into account the resulting U.S. tax advantage. Instead, Possessions-risk reinsurance business generally has comprised only a small component of a CFC reinsurer's total business involving risks located in many different parts of the world.

The result of subjecting such Possessions-risk reinsurance business to current U.S. taxation thus likely will be either (1) to necessitate an increase in reinsurance premium rates, and in turn an increase in the rates charged for primary coverages; or (2) to discourage CFC reinsurers from reinsuring Possessions-risk business altogether. Either result could have serious, adverse ramifications for the Possessions. Raising premium rates could well place life, accident and health and other basic insurance protection out of the reach of many individual Possessions residents. The withdrawal of CFC reinsurers from Possessions-risk reinsurance business could exacerbate the already-mounting strains on Possessions insurance capacity.

We doubt that Congress intended or contemplated such results when it amended section 953(a). Indeed, Congress exercised special care to ensure that the 1986 Act, notwithstanding its broad-based changes, would not materially alter or diminish the historic U.S. tax policy, reflected in section 936 and allied Code provisions, to foster economic development in the Possessions. It is submitted that amended section 953(a), in the narrow context described, operates at cross-purposes with this historic tax policy.

Impact on U.S. Competitiveness. A second, likely effect of amended section 953(a) will be to place U.S.-owned, third-country-based reinsurers writing Possessions-risk reinsurance business at a serious, competitive disadvantage in relation to their foreign-owned counterparts. For example, the U.K., France and Switzerland, which are the domiciles for some of the world's largest commercial insurers, have within their tax laws no provision comparable to section 953(a). As a consequence, a U.K., French or Swiss insurer's third-country-based reinsurance subsidiary could write Possessions-risk reinsurance business without subjecting the profits from such business to current taxation in the U.K., France or Switzerland.

To the extent the result of amended section 953(a) is to increase reinsurance premium rates in respect of Possessions-risk reinsurance business, or to discourage U.S.-owned foreign insurers from entering, expanding or continuing that business, the vacuum likely will be filled by less competitively-disadvantaged reinsurers from other countries. In the present climate of concern regarding U.S. competitiveness abroad, and particularly with respect to business involving the U.S. Possessions, it is submitted that this result is inappropriate and economically counterproductive.

* * *

We have attached for your consideration draft language that would appear to us to resolve the narrow but serious problem described above. We of course would be pleased to provide any further information you might want or to meet with you to discuss this in greater detail.

Sutherland, Asbill & Brennan

Attachment

Proposed New Section 953(b)(5):

> There shall be excluded from "insurance income" any income attributable to the reinsuring of any insurance or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of, any possession of the United States.

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July 8, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I believe that, as drafted, Section 112(h)(1)(A) of H.R. 2636 would effectively bar many off-shore captive insurance companies not normally considered controlled foreign corporations from being able to make an election under Section 953(c)(3)(C). This letter elaborates on the problems I perceive inherent in the language of the Technical Corrections Bill, problems not contemplated by its drafters.

Section 951(a)(1) provides that only United States shareholders owning stock in a CFC are taxed on Subpart F income. Yet the technical rules of Subpart F can lead to the anamolous result of a foreign corporation being considered a CFC even if it had no stockholder who could be taxed on its Subpart F income. The broad attribution rules of Section 958(b) make it possible for United States partnerships or trusts to be considered United States shareholders even if they own no stock, such stock being owned by and attributed from their partners and beneficiaries, and such attribution rules could cause a foreign corporation without any United States shareholders owning stock to be considered a CFC.

An example illustrates the point. Assume 200 independent New York taxi drivers form an off-shore captive insurance company to insure an excess portion of their liability risks. Assume further that these persons participate in a cost sharing arrangement for a radio-dispatch system and that this arrangement could be considered a partnership for United States tax purposes. Under these circumstances, the "U.S. partnership" is deemed to own all of the stock of the foreign captive thus causing the foreign captive to be considered a CFC. But no one is taxed on the CFC's Subpart F income!

Virtually all association captives originate from within a common industry. Industry participants typically have a number of relationships, cost sharing or otherwise, that could be classified as partnerships. If any relationship, within a common industry, no matter how insignificant, could be characterized as a U.S. partnership, that industry's captive could be considered a CFC and Section 112(h)(1)(A) of the Bill, as currently written, would deprive the captive from making an election under Section 953(c)(3)(C). Surely this is not intended.

The purpose of Section 112(h)(1)(A) is, I understand, to stop CFC's with Subpart F income that is currently taxed to their United States shareholders without regard to Section 953(c) from avoiding this tax by making the Section 953(c)(3)(C) election. The description of the Bill makes this clear: "Thus, the bill clarifies that the election is available only in situations where a foreign corporation and its shareholders are subject to subpart F treatment by virtue of the Act's special insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context" [Emphasis added]. Description of the Technical Correction Acts of 1987 at XII C 1.

As drafted, Section 112(h)(1)(B) makes it virtually impossible for an association captive to make a Section 953(c)(3)(C) election with certainty. An association captive would not normally know, and would have a great deal of difficulty finding out, if there existed any arrangements amongst its shareholders that would be considered U.S. partnerships and, under the attribution rules, cause it to be a CFC.

Perhaps Section 112(h)(1)(B) could be redrafted to read as follows: "Any election under this subparagraph made for any taxable year shall not be effective if the corporation (or any predecessor thereof) had income that (without regard to this subsection) was includable in the gross income of one or more United States shareholders under section 951(a) for the taxable year for which the election was made or any prior taxable year beginning after 1986." With this change it would be possible for an association captive to make the election with a fair degree of certainty that it could do so under the law.

If you have any questions, please don't hesitate to contact me.

With best regards.

Very truly yours,

David W. Welles

Section 1235

Coalition to Exclude Operating Income
From the PFIC Provisions
c/o Baker & McKenzie
815 Connecticut Ave. N.W.
Suite 1100
Washington, D.C. 20006
July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: H.R. 2636: The Technical Corrections Act of 1987--Section 112(n): Amendments Relating to Section 1235 of the Reform Act--Sections 1291-1297 of the Internal Revenue Code

Dear Mr. Leonard:

We represent the Coalition to Exclude Operating Income from the PFIC Provisions and are submitting these comments on behalf of the Coalition. The membership of the Coalition consists of United States corporations with foreign operating subsidiaries. The Coalition was organized because the Passive Foreign Investment Company ("PFIC") provisions enacted as section 1235 of the Tax Reform Act of 1986 (codified as sections 1291-1297 [1]) would apparently classify many of their foreign operating subsidiaries as PFICs. Such classification would subject them to current U.S. taxation on the operating income of their foreign subsidiaries. We believe such a result is a technical oversight in the Tax Reform Act, and was clearly not intended by Congress.

The Coalition is fully supportive of the amendments to the PFIC provisions contained in section 112(n) of the Technical Corrections Act("TCA"). However, such proposed amendments do not address the Tax Reform Act's failure to exclude U.S. shareholders of controlled foreign corporations ("CFCs"), who are already subject to current U.S. taxation of passive income earned by their CFCs, from the PFIC provisions. We believe that the application of the PFIC rules to U.S. shareholders of CFCs was not intended by Congress.

As demonstrated more fully below, neither the House nor the Senate provisions dealing with PFICs affected the taxation of U.S. shareholders (as defined in section 951(b)) of CFCs (as defined in section 957). In addition, the Conference Agreement, as summarized in August 1986, did not indicate that this aspect of the PFIC provisions had been altered in any way by the Conferees. However, the final version of the statutory PFIC provisions failed to exclude such U.S. shareholders of CFCs, notwithstanding the fact that they were already subject to current U.S. taxation on all of the categories of passive investment income covered by the PFIC provisions.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986.

A. The House Bill.

The House was concerned generally that certain well-placed individuals could invest in offshore mutual funds holding passive assets in a manner that allowed them to defer taxation on current income of the funds and to repatriate such income at favorable capital gains rates. The Subpart F, personal holding company, and foreign personal holding company provisions, designed to require current inclusion of passive income, could be avoided by keeping U.S. owners as a minority of the shareholders of the offshore fund. Further, the foreign investment company provisions of section 1246, designed to require ordinary income treatment on gains from the sale of offshore mutual fund stock, could be avoided by keeping U.S. ownership of the investment fund at half or less and by limiting the total number of U.S. persons investing in the fund to fewer than 100. Because of these various limitations, this loophole was available only to a few well-placed Americans. The House thought this loophole was unfair, and closed it. 2/

The House Bill accomplished this by defining certain foreign corporations as PFICs, using the same passive income or passive asset test as was eventually enacted in section 1296. It then treated all PFICs and their shareholders as CFCs fully subject to Subpart F, regardless of the proportion of U.S. ownership or the percentage of stock held by a particular U.S. person. Further, the House Bill also subjected offshore mutual funds to the ordinary income recharacterization rules of section 1246 regardless of the level of U.S. ownership. The result was that U.S. investors in offshore mutual funds would be currently taxable on the fund's income, all of which would normally be passive, and would be taxed at ordinary rates on any gain from the sale or redemption of shares in such a fund.

Because the House Bill addressed the problem by expanding the definition of "U.S. shareholder" and "CFC," it had no impact on those taxpayers who were already U.S. shareholders of CFCs. Consequently, under the House Bill, the normal rules for taxation of income earned through foreign subsidiaries, contained in the Subpart F provisions of the Code, would have continued to apply to such U.S. shareholders.

The House Bill and its legislative history contained no hint that the normal rules for taxing U.S. shareholders were to be altered. Stated differently, the House Bill never contemplated or suggested that the PFIC rules should have the effect of causing the current inclusion of income of a CFC in its U.S. shareholder's income where such CFC income was operating income not subject to the current inclusion rules of Subpart F.

Significantly, the revenue estimate for the House Bill's provision was only $85 million over five years, thus clearly signifying the limited nature of the loophole being closed.

B. The Senate Bill.

The Senate Bill also closed the loophole identified by the House Bill, and for the same reasons, but did so in a substantially different manner. Nevertheless, it retained the House Bill's definition of a PFIC, and subjected holders of PFIC stock to a regime of taxation similar to that appearing in the PFIC provisions as finally enacted.

2/ H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985).

Most importantly, however, the Senate Bill specifically excluded U.S. shareholders of CFCs from the application of the PFIC provisions, apparently on the theory (obviously accurate) that such U.S. shareholders were already subject to current U.S. taxation on any passive income earned by their CFCs, and ordinary income treatment (via the gain recharacterization rules of section 1248) on any gain from a disposition of CFC stock. [3]

Moreover, the Senate Bill permitted any taxpayer otherwise subject to the PFIC rules to elect to be treated as a U.S. shareholder of a CFC, so that Subpart F, and not the PFIC provisions, applied. As was the case in the House, there was no hint of any intent to subject U.S. shareholders of CFCs to current taxation on the operating income earned by their CFCs. To the contrary, the election to be treated under Subpart F rather than the PFIC rules, which was available to all U.S. persons who were not U.S. shareholders in CFCs, constituted an affirmative recognition by the Senate that such income need not be subject to current inclusion.

Again indicating the limited nature of the loophole being closed, the Senate estimated that the total revenue pickup from the PFIC provisions would be $82 million over a five-year period.

C. The House and Senate Bill Compared.

A comparison of the PFIC provisions in both the House and Senate Bills reveals two important conclusions: First, both chambers agreed that the PFIC provisions should not affect the taxation of U.S. shareholders of CFCs. Second, both chambers agreed that the application of the Subpart F rules was a complete remedy for the loophole identified. On this latter point, the House signified this intent by actually placing PFICs and their shareholders under the Subpart F rules, while the Senate did so by making Subpart F an alternative at the option of the taxpayer.

From this, it is clear that it was never the intent of either the House or the Senate to subject U.S. shareholders of CFCs to current U.S. taxation or a deferred interest charge on the operating income of their CFCs under the PFIC rules.

D. The Conference Agreement of August 16, 1986.

When the House-Senate conferees met to resolve differences between the two versions of the tax reform bill, they had only the texts of the House and Senate bills to consider. In arriving at the final bill, they did not consider statutory language, but rather were presented with short summaries of possible compromises by the various staffs, i.e., House Ways & Means Committee staff, Senate Finance Committee staff, and Joint Committee on Taxation staff. As far as we are aware, none of these summaries suggested that U.S. shareholders of CFCs be made subject to the PFIC provisions.

On August 16, 1987, the staff of the Joint Committee on Taxation issued, at 8:30 P.M., a summary of the final agreement by the House-Senate conferees on the tax reform provisions (the "August 16 Summary"). It is this document which was the basis for the formal Conference approval of the Tax Reform Act that occurred later that same evening. The full text of the August 16 Summary with respect to the PFIC provisions was as follows:

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[3] H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill). S. Rep. No. 313, 99th Cong., 2d Sess. 397 (1986).

> 8. **Foreign investment companies**
>
> **Tentative agreement.**--Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on the identification of income character and with technical amendments.

August 16 Summary at 61.

This short statement indicates that the provision in the Senate Bill exempting U.S. shareholders of CFCs from the application of the PFIC rules was retained in the final Conference Agreement. The elimination of such exemption is not specifically mentioned, and such elimination, which would greatly expand the scope of the PFIC rules, cannot reasonably be called a "technical amendment."

Two weeks later, on August 29, 1986, the staff of the Joint Committee on Taxation published a more formal summary of the Conference Agreement ("August 29 Summary"). 4/ In its entirety, this new summary described the Conference Agreement as follows:

> 6. Foreign Investment Companies (FICs)
>
> Present law is amended to require either payment of an interest charge on eventual recognition of income earned by U.S. investors through passive FICs (subject to a gain limitation) or current recognition, and to apply these rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. This provision is effective for taxable years beginning after 1986.

August 29 Summary at 61.

As with the August 16 Summary, there is no hint that the PFIC provisions would subject U.S. shareholders of CFCs to current taxation or a deferred interest charge on operating income of CFCs.

E. The Final Statute.

The statutory language of the Tax Reform Act of 1986 was not released to Congress until September 18, 1986. It was over 900 pages long, and contained substantial errors, both technical and substantive. Nevertheless, the House passed the Act on September 25th, and the Senate on September 27th; no corrections were made to deal with the errors. Indeed, it was manifestly impossible, in such a short time, to identify and correct all the errors in so massive a piece of legislation.

The PFIC provisions of the Act had been substantially redrafted when compared to the Senate Bill's provisions. Importantly, the provision contained in the Senate Bill exempting U.S. shareholders of CFCs was omitted.

The Conference Report, published simultaneously with the Act, gives no hint that U.S. shareholders of CFCs would be subject to the PFIC provisions. In fact, it discusses the

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4/ Staff, Joint Committee on Taxation, Summary of Conference Agreement on H.R. 3838 (Tax Reform Act of 1986) (JCS-16-86) (August 29, 1986).

provision solely in the context of passive offshore investment funds. The major effect of the Act's PFIC provisions is to eliminate the benefit of deferral from current taxation of income earned by a PFIC. [5] In this regard, the Conference Report states that these provisions were aimed exclusively at offshore investment funds:

> The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.

H.R. Rep. No. 841, 99th Cong., 2d Sess. II-641 (1986).

The Conference Report also states that: "The conferees do not intend that foreign corporations owning the stock of subsidiaries engaged in active businesses be classified as PFICs." Id. at II-644. This further indicates that foreign subsidiaries that are directly engaged in active businesses were never considered by Congress to be subject to PFIC treatment. Nevertheless, as described below, the omission from the Act of the Senate Bill provision exempting U.S. shareholders of CFCs will have that result unless the omission is corrected.

F. Congressional Approval of Deferral--Subpart F.

Subpart F was passed in 1962 so as to eliminate the use of foreign subsidiaries to obtain deferral of U.S. tax, where such subsidiaries were engaged in specified "tax haven"-type activities or earned specified "tax haven"-type income. Since 1962, Subpart F has served to guard against the use of a foreign corporation to obtain deferral of U.S. tax with respect to types of activities or income that Congress believed should be subject to current U.S. tax. In this regard, Congress has refined the definition of "Subpart F income," i.e., income subject to current inclusion in the U.S. shareholder's income under the rules of Subpart F, over the years, most recently in the Tax Reform Act of 1986, to assure that U.S. shareholders cannot use CFCs to gain the benefit of deferral on passive investment income and carefully defined categories of foreign base company income.

Importantly, however, Congress has always permitted deferral of U.S. taxation on operating income not included in the definition of Subpart F income. In both 1962 and 1976, Congress was presented with the option of eliminating deferral on all income of foreign subsidiaries regardless of its type, and it considered the matter on an in-depth basis both times. Both times it rejected the elimination of deferral with respect to operating income generally as being against the interests of the United States in promoting the international competitiveness of United States business.

The evolution of Subpart F represents the direct and cumulative judgment of Congress as to what types of income should be subject to current U.S. tax when earned by foreign subsidiaries of U.S.-based multinational corporations. 6/ Indeed, in light of this background, it is not surprising that neither the House nor the Senate bills, in their PFIC provisions, would have affected U.S. shareholders of CFCs who were already covered by the Subpart F provisions. It is surprising, however, that the Conference bill would effectively reverse the long-standing Congressional judgment that operating income of CFCs generally should not be taxed currently to their U.S. shareholders.

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[5] The benefit of getting capital gains treatment on disposition of stock in a foreign investment fund was, of course, eliminated by the repeal of the capital gains/ordinary income rate differential.

G. The Effect of the Asset Test on Operating Companies.

Unfortunately, the PFIC provisions as enacted, if not corrected, would effectively override Congress's judgment that non-Subpart F income should be eligible for the benefit of deferral. In effect, the PFIC provisions would swallow up the careful distinctions made by Subpart F, subjecting all income of CFCs, regardless of type, to the economic equivalent of current U.S. taxation. For instance, a wholly owned foreign manufacturing subsidiary of a U.S. corporation could quickly become a PFIC because of its accumulation of assets not directly used in its day-to-day business. This result occurs because of the mechanical operation of the asset test, when unchecked by an exemption for U.S. shareholders of CFCs. 7/

Under the asset test, any foreign corporation is a PFIC if half or more of the average value of its assets consists of assets producing passive income or assets held for the production of passive income. Thus, if an active CFC accumulates profits with a view to further expansion of its operations, it could quickly find itself a PFIC if its operations are particularly profitable. Further, certain assets, such as trade accounts receivable, often account for a substantial portion of the "asset" value of a CFC, and such assets might well be classified as passive assets under the PFIC rules. 8/ Similarly, manufacturing facilities which are temporarily closed, real estate purchased with a view towards construction of new manufacturing facilities in the future, and the like, could result in PFIC status for a CFC which is in an active business.

Without the exemption for U.S. shareholders in CFCs from the PFIC provisions, a great many active foreign business operations would be potentially subject to the PFIC rules, despite the fact that the vast majority of their income was non-tax haven-type income. Clearly, foreign operating subsidiaries of U.S. corporations are not offshore investment funds of the type that

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6/ Notably, these safeguards include requiring current inclusion of all of a CFC's income in the taxable income of its U.S. shareholders where the CFC is used primarily (but not exclusively) to earn tax haven-type income, that is, where more than 70 percent of the CFC's gross income is tax-haven-type income. § 954(b)(3)(B).

7/ Notably, the passive income test does not pose a problem for a CFC. As noted, if more than 70 percent of its gross income is passive, all of the CFC's income is subject to current inclusion in the U.S. shareholder's taxable income under the Subpart F rules. This percentage is less than the 75 percent passive income threshhold for application of the PFIC provisions.

8/ See section 954(c) (defining non-income-producing assets as "passive" assets).

concerned Congress in enacting the PFIC provisions, and Congress could not have intended to subject them to the PFIC rules.

If Congress had intended to end deferral on non-Subpart F income, Congress would have faced the issue head on, and done so by modifying the Subpart F provisions. As shown above, however, Congress has refused to take this step every time that it has been faced squarely with the issue.

H. Status as Technical Amendment.

As demonstrated above, neither the House nor the Senate ever indicated any intention that U.S. shareholders of CFCs be subject to the PFIC rules. Rather, they consistently indicated that Subpart F was the exclusive and adequate safeguard against tax abuse in such situations. The Conference Agreement, as expressed in August, clearly envisions the incorporation of the provisions of the Senate Bill in the final Act, and this must have included an intent to retain the exclusion from the PFIC rules found in the Senate Bill, in view of the fact that there was no difference between the House and Senate Bills on this point.

Subpart F has for twenty-five years expressed Congress's considered policy judgment with regard to the proper taxation of U.S. shareholders of CFCs. This was recognized by both the House and Senate Bills. A major reversal of this policy is nowhere hinted at in the legislative history of the PFIC provisions. Rather, that history, fairly read, indicates that those provisions are directed solely at taxation of passive income earned through offshore mutual funds and similar types of passive investment vehicles.

It is simply incomprehensible that such a major change in the tax regime governing U.S. shareholders of CFCs could have occurred intentionally without some discussion or some hint that Congress so intended. Rather, it seems obvious that the omission of the provision in the Senate Bill exempting U.S. shareholders of CFCs from the PFIC provisions was a technical "glitch."

Further evidence that this omission was unintentional may be gleaned from the fact that the revenue estimate appearing in the Conference Report was only $82 million over a five-year period--exactly the same estimate as contained in the Senate Finance Committee Report. The expansion of the PFIC rules to cover the operating income of foreign operating subsidiaries, as compared to the Senate or House Bills, would clearly result in substantially higher revenues. Consequently, it seems obvious that the only intended target of the PFIC provisions was the original loophole identified by the House.

Accordingly, we respectfully submit the following amendment to section 112(n) of the Technical Corrections Act: 9/

> (25) Subsection (b) of section 1297 of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> "(9) EXCEPTION WHERE SECTION 951 APPLIES.--This part shall not apply to a taxpayer with respect to a corporation if, without regard to this Part--
>
> "(i) such corporation is a controlled foreign corporation (as defined in section 957), and

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9/ This amendment is identical to the exclusion in the Senate Bill, H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill), with the exception that the term "Part" has been substituted for "section" to reflect the PFIC provisions as enacted.

> "(ii) the taxpayer is a United States shareholder (as defined in section 951(b)) with respect to such corporation."

We respectfully request that the Committee on Ways & Means add this provision to the Technical Corrections Act.

I. Clarification That Section 904(d) Look-Thru Rules to Apply for Purposes of the PFIC Provisions.

The Coalition also believes that a similar technical oversight exists with respect to the application of the "look-thru" rules of section 904(d)(3) and (d)(5) in determining what constitutes "passive income" for purposes of the PFIC rules. The Senate Bill contained a specific provision applying the section 904(d)(3) "look-thru" rules, with certain modifications, to the determination of "passive income." 10/ This statutory provision was omitted from the PFIC provisions as enacted. 11/

The Joint Committee staff description of the TCA PFIC amendments states the following, in this respect:

> By incorporating the definition of passive income that is applied for foreign tax credit limitation purposes, the look-through rules contained therein (*i.e.*, secs. 904(d)(3) and (d)(5)), are, to the extent applicable, applied in determining whether income is passive for PFIC purposes as well.

Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)* 209 (JCS-15-87) (June 15, 1987).

Despite this, it is by no means clear that the cross-reference contained in section 1296(b)(1) encompasses the look-thru rules of section 904(d)(3) and (d)(5). We accordingly believe the following addition to section 112(n) of the Technical Corrections Act would be appropriate:

> (26) Subsection (b) of section 1297 of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> "(3) APPLICATION OF LOOK-THRU RULES OF SECTION 904(d). For purposes of paragraph (1), the rules of sections 904(d)(3) and 904(d)(5) shall apply."

We respectfully request that the Committee on Ways & Means add this provision as well to the Technical Corrections Act.

Respectfully submitted,

Robert McClory

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Attorneys for the Coalition
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From the PFIC Provisions

10/ H.R. 3838, § 925(a) (Code section 1246A(f)(2)(B)) (Senate Bill).

11/ *See* § 1296(b)(1).

July 17, 1987

BY HAND

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Subject: Technical Corrections Act of 1987 - Overlap Between Passive Foreign Investment Company and Controlled Foreign Corporation Provisions

Dear Sir:

Pursuant to Ways and Means Committee press release No. 12, dated June 10, 1987, and on behalf of a group of companies from several diverse industries, six copies of comments[1] are hereby submitted on the Technical Corrections Act of 1987 (the "Bill")[2] relating to the application of the passive foreign investment company ("PFIC") provisions found in sections 1291 through 1296 of the Internal Revenue Code of 1986 ("Code").[3] As discussed below, we would suggest a technical amendment coordinating the PFIC rules and the rules applicable to U.S. shareholders of controlled foreign corporations ("CFCs").

Background

A foreign corporation is a PFIC if 75 percent or more of its gross income consists of "passive income" or if at least 50 percent of the average value of its assets produce, or are held to produce, passive income. PFIC status is determined without regard to the quantum of stock owned by U.S. persons. The PFIC provisions apply to taxable years of foreign corporations beginning after December 31, 1986.

Generally, the PFIC provisions provide two alternative regimes. One generally imposes the maximum rate of tax, and an interest charge attributable to periods of deferral, on any direct or indirect U.S. person shareholder of a PFIC in respect of certain distributions from, and dispositions of, stock of the PFIC ("interest charge rules"). In the alternative, the PFIC may elect to be treated as a qualified electing fund ("QEF") which generally requires current inclusion in the income of any direct or indirect U.S. person shareholder of all of the earnings of the PFIC.

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[1] The original deadline for comments was July 10, 1987. The deadline was extended to July 17, 1987, by Ways and Means Committee press release No. 15, dated July 7, 1987.

[2] H.R. 2636 and S.1350, 100th Cong., 1st Sess. (June 10, 1987).

[3] Unless otherwise specified, all section references are to the Code or to the regulations thereunder.

Generally, a 10 percent U.S. person shareholder of a CFC is subject to tax currently under section 951 in respect of the CFC's "subpart F income," which includes the CFC's passive income. Thus, a U.S. shareholder derives no deferral of tax in respect of the passive income of a CFC.

Problem

The legislative history indicates that the PFIC provisions were designed to discourage U.S. investments in passive foreign investment funds in preference to domestic investment companies. Congress intended to remove the economic benefit of tax deferral, which in some cases could be derived from passive investments abroad, and the ability to convert ordinary income to capital gain, which in some instances could be obtained under prior law.[4] However, under the statutory definitions, many active businesses with substantial accumulated cash, or which have unprofitable operations, including many CFCs, also could be classified as PFICs (*e.g.*, foreign trading, service, financial, or manufacturing corporations). This could be true even though U.S. shareholders of CFCs already are taxed currently on their share of the CFCs' passive income under the subpart F provisions of sections 951-964 and even though such U.S. shareholders, under section 1248, cannot convert ordinary income into capital gain.

The overlap between the CFC and PFIC provisions could lead to particularly harsh results for U.S. shareholders of CFCs. For example, if a CFC (*e.g.*, engaged in manufacturing and sales), also is a PFIC, subsequent year actual distributions of tax-deferred earnings (which are not attributable to passive income and which are not subject to current inclusion under subpart F) would be subject to an interest charge. The interest charge rules also would apply to all of the gain upon the disposition of the stock of the CFC. The application of the interest charge rules to the U.S. shareholders of a CFC has the effect of terminating deferral of U.S. tax on income from active business operations with respect to which Congress has specifically retained deferral and where passive income derived by the CFC is already subject to current U.S. tax in the hands of U.S. shareholders. Such result inappropriately burdens the competitive positions of U.S. taxpayers operating abroad vis-a-vis their foreign competitors.

Many of the problems arising from lack of coordination between subpart F and the interest charge rules can be avoided if a qualified electing fund ("QEF") election is made. However, under the QEF election all of the CFC's earnings and profits would be subject to current inclusion under either the CFC or QEF rules. Thus, a CFC would be unable to defer tax on income specifically subject to deferral under subpart F rules, *e.g.*, a CFC engaged in manufacturing and sales, while passive income, to which the PFIC rules were directed, generally would have been included currently in the income of the CFC's shareholders in any event.

The breadth of the PFIC provisions results from the definition of a PFIC, the test for which is by reference to either income or assets, and the failure of the PFIC rules to adequately coordinate with the subpart F. This lack of coordination with the subpart F provisions was apparently unintended. Both the House and Senate versions of the Tax Reform Act of 1986 (the "Act") coordinated the PFIC and CFC provisions. Under the House version of the Act, a PFIC would have been treated as a CFC, and all of its U.S. person shareholders would have been treated as U.S. shareholders of a CFC, regardless of whether they satisfied the 10 percent ownership threshold under the CFC provisions.[5] Thus, although CFCs potentially could be subject to the PFIC provisions under the House version of the Act, deferral of U.S. tax on income from active business operations would have been retained. Under the Senate version of the Act, a U.S. person shareholder of a PFIC could elect to be treated as a U.S. shareholder of a CFC without regard to whether such person met the 10 percent ownership threshold.[6] More importantly, under the Senate version, the PFIC provisions did not apply to a U.S. investor if the PFIC was otherwise a CFC and the investor was otherwise a U.S. shareholder under the CFC provisions.[7] The Conference Committee report also suggests that the conferees believed that the PFIC provisions included coordination with subpart F.[8] However, this intent has not been implemented and the technical drafting of the statute unintentionally undercuts Congress' subpart F policy.

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[4] H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 393-94 (1986).

The unintended failure of the Act to fully coordinate the CFC and PFIC provisions represents not only a fundamental change in the PFIC provisions as previously proposed by the House and Senate, and as apparently agreed to by the Conference Committee, but also in the U.S. taxation of foreign corporations generally. We believe that the effective termination of deferral of U.S. tax on income from active business operations should be carefully deliberated and effected, that taxpayers should have the opportunity to provide input on the issue, and that any such change should not be included in an obscure provision relating to passive foreign investment companies. To subject to current tax the active business income of CFCs will undermine such companies' ability to compete internationally.

Recommendation

We believe that where a PFIC is also a CFC, the CFC provisions should take priority. In that case, 10 percent or more U.S. person shareholders of a CFC should be subject solely to the subpart F provisions and should not be subject to the PFIC provisions. Thus, we would recommend a technical correction which provides that the PFIC provisions do not apply to a U.S. shareholder of a CFC.

We appreciate the opportunity to comment on the Bill. If you have any questions or comments, please contact me at (202)862-2200.

Respectfully submitted,

A.W. Granwell/of

A.W. Granwell

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[5] H.R. 3838, 99th Cong., 1st Sess. § 625(b), 131 Cong. Rec. H12579 (1985).

[6] H.R. 3838, 99th Cong., 2nd Sess. § 925(a), 132 Cong. Rec. S8817 (1986).

[7] *Id.*

[8] H.R. Rep. No. 841, 99th Cong., 2nd Sess. II-645 (1986).

GROOM AND NORDBERG
CHARTERED

July 17, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office
Building
Washington, D.C. 20515

Re: Passive Foreign Investment Company Provisions

Dear Mr. Leonard:

The following is submitted for the record on H.R. 2636 on behalf of an ad hoc group of clients of Groom and Nordberg, representing a broad cross section of American industries, including pharmaceutical, electronics, natural resources and food products.

The 1986 Act created a new entity referred to as a Passive Foreign Investment Company ("PFIC"). Despite the reference in its name to passive income, the PFIC provisions, as enacted, apply to the active business income of a controlled foreign corporation ("CFC"), as well as to passive income. For the reasons discussed below, we believe that the application of these provisions to the active business of a CFC is inappropriate and beyond the stated purpose of the PFIC provisions.

The PFIC provisions, as enacted, apply to any foreign corporation, including a CFC, if 75 percent or more of its gross income for the year is passive income or if 50 percent or more of its assets (by value) produce passive income. Many CFCs (including wholly-owned subsidiaries) that are engaged in a substantial trade or business have substantial accumulated income and could "qualify" as PFICs.

In general, but for the PFIC provisions, the active business income of a CFC is not subject to U.S. taxation until this income is distributed to the U.S. shareholders. This basic concept of U.S. tax law is commonly referred to as deferral. On the other hand, the passive investment income of a CFC is subject to current taxation under the subpart F provisions. In addition, a CFC is subject tocurrent taxation on income derived from a variety of activities for which Congress has concluded tax deferral is not justified. This income is generally referred to as foreign base company income. If the foreign base company income constitutes over 70 percent of the gross income of a CFC, all of the income of the CFC is subject to current taxation. Thus, subpart F contains a comprehensive set of rules concerning when the earnings of a CFC should be subject to current taxation. These rules do not generally eliminate deferral for active business income unless derived from base company or other specified activities.

The effect of the PFIC provisions is to eliminate deferral on all types of active business as well as passive income. A PFIC's shareholders are subject to an interest charge on all excess distributions from the PFIC. The charge is based upon the period of time that the amount distributed enjoyed the benefit of deferral. The charge, in effect, eliminates the benefit of deferral for these distributions, including distributions paid out of earnings derived from an active business. The only means of avoiding the interest charge is to become a qualified electing fund. In such a case, all income of the PFIC is currently taxed to its shareholders, including income derived from an active business.

Eliminating deferral on active business income is inappropriate for several reasons. It is a long-standing fundamental principle of international taxation followed by the United States (and all developed countries) that the earnings of a foreign corporation are not subject to U.S. tax until they are remitted to the U.S. shareholders. Numerous proposals have been made in the past to eliminate deferral for active business income. Congress, however, has always rejected these proposals. The principal reasons that these proposals have been rejected are as follows:

1. Practically all industrialized nations permit deferral for active business income of foreign subsidiaries until repatriated. Thus, if the United States eliminated deferral for active business income, there would be a higher tax burden on U.S.-owned foreign corporations than on foreign-owned companies. This would place U.S.-owned foreign subsidiaries at a competitive disadvantage and reduce the American share of these foreign markets. Since foreign-owned companies would seize the investment opportunities abroad, the loss of these markets would directly reduce domestic employment currently generated by supplying materials, technology, and supportive services to U.S.-owned foreign affiliates.

2. American companies that export substantial amounts of goods and products need to have significant overseas operations in connection with their U.S. production in order to minimize high tariffs and other export costs. The elimination of deferral for active business income would damage these companies' ability to export.

3. The elimination of deferral would increase the tax burden on subsidiaries of U.S. companies located in foreign countries which have low effective tax rates. Such countries would be encouraged to increase their taxes applicable to United States-owned enterprises because the total tax burden on the investment would not be changed, and the tax revenue which would otherwise go to the United States Treasury would be retained by the foreign country.

4. Deferral allows the tax incentives given by developing countries to be effective for foreign subsidiaries of U.S. companies. Denying these benefits will be resented by foreign governments as interference in their domestic affairs. Further, the impact will be more adverse for investment in developing countries than in developed countries. For example, Ireland is able to attract companies that wish to invest in a country in the European Economic Community (EEC) in order to avoid the high tariff on imports from non-member countries. If deferral is eliminated, these companies will still invest inside the EEC, but on the continent rather than in Ireland.

Consistent with longstanding U.S. policy favoring deferral, neither the House nor the Senate PFIC provisions would have subjected U.S. shareholders of CFCs to current taxation on their active business income. The House provision would have treated a PFIC as a CFC and would have treated each U.S. person who owns stock in a PFIC as a U.S. shareholder of a CFC. Thus, the House provision by extending the treatment of U.S. shareholders of CFCs to U.S. persons who own stock in a PFIC would have eliminated deferral for the passive income of a PFIC not otherwise subject to Subpart F. Moreover, the Senate provision contained an election that PFIC treatment would not apply if a U.S. person elected to be treated as a U.S. shareholder of a CFC. Thus, both the House and Senate bills would have eliminated deferral for passive investment income but not active business income.

The effective elimination of deferral on active business income is the fundamental defect associated with PFIC status. Given the fact that neither the House nor the Senate PFIC provisions would have subjected U.S. shareholders of CFCs to current taxation on active business income and the failure of the bill as approved by the Conference to provide for a section 902 credit and relief from double taxation of income that has been previously taxed under subpart F, it is fair to say that Congress paid little attention to the applicability of the PFIC provisions to CFCs.

The legislative history also demonstrates an intention to apply the PFIC provisions to tax passive investment income earned by foreign corporations where the subpart F provisions were not applicable. For example, the General Explanation states at pages 1023 to 1024:

- Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation. Congress further believed that the nationality of the owners of controlling interests of a corporation which invests in passive assets should not determine the U.S. tax treatment of its U.S. owners. In Congress's view, the absence of U.S control did not necessitate preferential U.S. tax treatment to U.S. persons who invest in passive assets through a foreign corporation. Moreover, Congress recognized that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they not only were able to avoid current taxation but also were able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income.

- Under prior law, a U.S. investor may never have been fully taxed on his or her share of a foreign investment company's accumulated earnings. Congress noted that if similar income were generated by a domestic investment company or was otherwise currently subject to U.S. tax, the U.S. investor would have been taxed on the full amount of income. In Congress' view, if current taxation of a passive foreign investment company's actual income is required, U.S. investors should be taxed on their entire share of the company's earnings, regardless of whether the earnings are distributed.

Nowhere in the Reasons For Change portion of the General Explanation is there any reference to, or a policy discussion of, the taxation of the active business income of CFCs. Moreover, the revenue estimate of the provision, as enacted, is identical with the revenue estimate of the Senate provision and almost identical to the revenue estimate of the House provision. If there had been a clear understanding that active business income of CFCs would be taxed under this provision, as enacted, the revenue estimate would have been significantly increased.

For the reasons stated above, we do not believe it is sound policy to eliminate deferral for active business income. Even those that may have a contrary view would agree, we trust, that such a fundamental change should not have been made without specific acknowledgement and debate of the results of the change.

The purpose of the PFIC provisions was to eliminate deferral for passive income. To accomplish this purpose, it is unnecessary to apply these provisions to U.S. shareholders of CFCs because subpart F already eliminates deferral for passive income in this situation. If the PFIC provisions are applied to U.S. shareholders of CFCs, deferral is also eliminated for active business income of CFCs. We believe this result is unsound tax policy and was not intended by Congress. Accordingly, H.R. 2636 should exclude U.S. shareholders of CFCs from the application of the PFIC provisions.

Respectfully submitted,

Carl A Nordberg Jr
Carl A. Nordberg, Jr.

Statement of the
Machinery and Allied Products Institute
to the
Ways and Means Committee
United States House of Representatives

The Impact of the Passive Foreign Investment Company Provisions on Foreign Operating Subsidiaries of U.S. Multinationals

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment on H.R. 2636, the Technical Corrections Act of 1987 (TCA). Because we are particularly concerned about the impact of the Passive Foreign Investment Company provisions of the 1986 Code on foreign operating subsidiaries of U.S. multinationals, our comments are focused on TCA Section 112(n) and the changes it would make to Code Sections 1291 through 1297.

The Passive Foreign Investment Company (PFIC) rules were added to the Code by the Tax Reform Act of 1986 (TRA).[1] It is our view that the PFIC provisions, as enacted, do not reflect Congressional intent because they effectively end deferral for many controlled foreign corporations (CFCs). We believe that in passing TRA, Congress did not intend to subject to current taxation (or the approximation thereof) non-subpart F income derived by manufacturing, service, and other operating foreign affiliates. Rather, Congress intended to address certain issues related to foreign incorporated investment funds and U.S. persons who are their shareholders. The extension to CFCs of House and Senate bill provisions directed at investment funds was a technical error, which is properly the subject of TCA.

Unless corrected, the PFIC provisions may compromise the competitive position of many U.S. multinationals with foreign affiliate operations, which now may be subject to the Code's PFIC provisions as well as its CFC rules. The CFC rules draw an important distinction between income derived from the active conduct of a trade or business and that derived from passive or tax haven-type investments. To the extent the PFIC provisions apply to CFCs, that distinction, crucial to U.S. multinational operations, is eliminated.

MAPI Interest

As you may know, MAPI is a leading business organization established in 1933 to represent producers and users of capital goods and allied products. Over the years, our membership has expanded to include electronics, telecommunications, office systems, aerospace and other high technology industries, as well.

Most of the Institute's member companies conduct business throughout the world, many through foreign affiliates which fall within the purview of the Code's Subpart F provisions. It appears that many of these affiliates may also be subject--and we believe unintentionally and inappropriately so--to the PFIC provisions.

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[1] Public Law 99-514, 100 Stat. 2085.

Summary of Comments

As already noted, Code Sections 1291-1297 were enacted to subject to current taxation the passive (and capital gains) income of certain foreign incorporated mutual or investment funds which for varying reasons were not subject to the CFC, foreign personal holding company (FPHC), personal holding company (PHC), or foreign investment company (FIC) provisions of the Code.

However, PFICs are so broadly defined and their operating rules are so ill-coordinated with the rules governing CFCs that solutions intended for foreign investment companies may totally disrupt the regime which has for 25 years effectively governed the taxation of U.S. shareholders with respect to their foreign operating affiliates that are CFCs.

While TCA Section 112(n) would correct certain of the more egregious features of the PFIC provisions as they apply to CFCs, it would not cure the most significant problem, which, as previously noted, is the application of the PFIC provisions to CFCs and their U.S. shareholders. Our comments may be summarized as follows:

-- Controlled foreign corporations (defined in Code Section 957) should be excluded from the Section 1296 definition of a PFIC and, at a minimum, U.S. shareholders (defined in Code Section 951(b)), should be excluded from the operation of Section 1291(a).

-- Congress did not intend to eliminate the distinction between Subpart F income which is currently includible in a U.S. shareholder's gross income and non-Subpart F income whose recognition by the U.S. shareholder is subject to deferral.

-- Statutory rules governing the valuation of operating assets for purposes of the Section 1296(a)(2) assets test are inadequately defined.

-- The amendments contained in TCA Section 112(n) reflect Congressional intent except to the extent that they do not exclude CFCs and their U.S. shareholders from the operation of the PFIC provisions.

Following a brief review of the background of TCA, we will elaborate on the comments summarized above.

Background

Controlled Foreign Corporations: A Summary of Pertinent Provisions

Controlled foreign corporations.--Except to the extent the PFIC provisions apply, the tax treatment of U.S. shareholders of CFCs is prescribed by Code Sections 951 through 964 (often referred to as Subpart F). Other Code provisions, of course, also may apply. Significantly, these include the foreign tax credit rules of Subpart A and Section 1248 which concerns the tax treatment of gain derived from certain sales or exchanges of stock in CFCs./2

2/ A number of other Code provisions, such as Sections 881 and 882 concerning direct taxation of foreign corporations, Sections 551 through 558 relating to foreign personal holding companies, and Sections 531 through 537 concerning the accumulated earnings tax, may also apply, but are not germane to this discussion.

Subpart F.--To briefly summarize, U.S. persons owning (directly, indirectly, or constructively) 10 percent or more of the voting power (U.S. shareholders) of a foreign corporation which is more than 50 percent, by vote or value, owned (directly, indirectly, or constructively) by U.S. shareholders (i.e., a CFC), generally, must currently include in gross income their pro rata share of income described in Code Section 951(a) (i.e., "Subpart F" income) derived by the CFC. A component of Subpart F income is "foreign personal holding company income" which is defined in Section 954(c) and includes, generally, dividends, interest, certain rents and royalties, gains from the sale of property which gives rise to such income (or does not give rise to any income), and gains derived from certain commodities and foreign currency transactions.

Generally, under Section 959, Subpart F inclusions, as previously taxed income (PTI), are not taxed again when distributed. When a U.S. shareholder sells or exchanges stock of a CFC, any gain recognized generally is included under Section 1248 in gross income as ordinary, dividend income to the extent of the CFC's earnings and profits that are attributable to the stock and that have not previously been included in income.

Foreign Tax Credit.--Under the "deemed paid" foreign tax credit rules of Section 902 and 960, generally, Subpart F inclusions and dividends in respect of CFCs (and certain other foreign corporations) can carry with them indirect credits for taxes paid by first, second, and third tier foreign subsidiaries. These credits, of course, are subject to the separate limitation and "look through" rules of Section 904.

Passive Foreign Investment Companies: Definition and Tax Treatment

Definition.--A PFIC is defined in Code Section 1296(a) as any foreign corporation if either (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. For these purposes, passive income is defined as income that is includible in the passive income separate foreign tax credit limitation of Section 904(d)(2)(A), without regard to the exceptions to the limitation. Thus, passive income generally includes dividends, interest and its equivalents, passive rents and royalties, and other passive-type income./3

Any U.S. person (without regard to the level of ownership and subject to certain attribution rules) who receives an "excess distribution" in respect of stock in a PFIC or disposes (or is treated as disposing) stock in a PFIC is subject to the special tax regime provided in the PFIC provisions. Total excess distributions are the aggregate amount of distributions received during the taxable year in excess of 125 percent of the average distributions received by the shareholder with respect to the stock during the three preceding taxable years. If more than one distribution is received during a taxable year, total excess distributions (if any) are allocated between them on a pro rata basis.

Tax treatment.--To briefly summarize, two alternative methods of taxation are provided. Under Section 1291(a), the U.S. person receiving an excess distribution or recognizing gain on the disposition of PFIC stock is subject to a deferred tax charge (at the maximum

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3/ For purposes of the income and assets tests, a foreign corporation that owns at least 25 percent (by value) of the stock of another foreign corporation is treated as receiving directly its proportionate share of that corporation's income and owning its proportionate share of the assets of that corporation.

corporate tax rates for the years in question) and an interest charge both of which are added to the taxpayer's tax liability for the year of distribution or disposition, with respect to amounts allocated (on a pro rata basis) to each of the PFIC's tax years beginning before January 1, 1987 and the current tax year./4 Amounts allocated to the current tax year and pre-effective date tax years are included in the shareholder's gross income and are treated as ordinary, dividend income.

Alternatively, a PFIC may elect under Section 1293 to be a qualified electing fund (QEF) and its income is then currently includible in the U.S. person's gross income. The U.S. person/shareholder may elect to defer tax on income deemed received from a QEF (subject to an interest charge) until a recognition event occurs (as provided in the statute).

Other rules.--If a PFIC is a QEF and a CFC, the Subpart F rules apply to the extent of income which is Subpart F income. The PFIC rules apply to income in excess of Subpart F income. No similar coordination is provided in connection with excess distributions or gain on disposition in respect of the stock of a PFIC which is not a QEF.

Section 1291(a)(5) provides that the deemed paid credit of Section 902 does not apply to any dividend paid by a PFIC which is not a QEF.

Section 1297(b)(1) provides that stock held by a taxpayer is treated as PFIC stock if, at any time during the holding period of the taxpayer with respect to the stock, the corporation (or any predecessor) was a PFIC which was not a QEF unless the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a PFIC) generally as though the taxpayer sold the stock at its fair market value. Section 1297 also provides rules concerning attribution of ownership, start-up years, certain corporations changing businesses, separate interests treated as separate corporations, and use of stock in a PFIC as security for a loan.

Technical Corrections Act

TCA contains a number of provisions affecting PFICs. These are found in its Section 112(n). Significantly, TCA would repeal Section 1296(a)(5) which denies the Section 902 deemed paid credit to PFICs that are not QEFs and would require excess distributions to be properly adjusted for income previously included in gross income by virtue of Subpart F, the foreign personal holding company rules, and the QEF rules.

Detailed Comments

PFIC Rules Should Not Apply to Controlled Foreign Corporations or Their U.S. Shareholders

The Code's Subpart F (together with Section 1248) and foreign tax credit provisions prescribe a thorough, well-thought-out scheme for U.S. taxation of U.S. shareholders of CFCs. Current taxation is provided with respect to "tax haven" type income. Ordinary income, dividend treatment applies to repatriation in the form of actual dividends or sale and exchange gain treated as dividend income.

4/ TCA would modify Section 1291(a)(1)(B)(ii) to clarify that the deferred tax charge rules apply only to PFIC taxable years which begin after December 31, 1986 and before the taxable year in which the distribution occurs.

This scheme is an effective and balanced mechanism for preserving residual U.S. taxation while properly limiting the reach of U.S. tax jurisdiction as it touches foreign source income and particularly foreign source operating income. CFCs should be excluded from the PFIC provisions because the CFC rules adequately protect U.S. tax jurisdiction. In our view, neither U.S. tax policy nor U.S. trade policy is served by grafting onto the CFC provisions a new regime which lacks the balance of the CFC rules in that it fails to account for the crucial distinction drawn in Subpart F between income derived from the active conduct of a trade or business and that derived from passive, tax haven-type investments.

Congress Did Not Intend To End Deferral For CFC Non-Subpart F Income

In our view, the legislative history of the PFIC provisions reveals that Congress did not intend to subject U.S. shareholders of CFCs to the PFIC provisions.

Both the House and the Senate bills contained provisions aimed at curing certain perceived abuses related to foreign incorporated investment funds. Generally, U.S. shareholders of such funds were viewed as avoiding current U.S. taxation on passive, tax haven-type income, because either the ownership of the fund was too widely dispersed to invoke the foreign personal holding company rules or the level of a U.S. shareholder's ownership or aggregate ownership by U.S. persons was not high enough to come within the ambit of the Subpart F rules. Similarly, the Section 1246 foreign investment company rules, which require ordinary income treatment on gains from the sale of stock, could be avoided by limiting the percentage of ownership by U.S. persons.

The House bill would have treated any foreign corporation meeting its PFIC test (generally that described in Section 1296) as a CFC, regardless of the proportion of U.S. ownership or the percent of stock held by a particular person. The Senate bill would have subjected PFICs (as now defined in Section 1296) to a special regime, largely similar to the present law PFIC rules, but would have exempted U.S. shareholders of CFCs from the application of the PFIC provisions and would have permitted _any_ taxpayer subject to the PFIC rules to elect to be treated as a U.S. shareholder of a CFC and to be taxed under the CFC rather than the PFIC rules.

Thus, under either bill, U.S. shareholders of CFCs would not have been subject to the PFIC rules and the impact of the PFIC rules would have been limited as intended to offshore investment funds.

Conference agreement.--The conferees on the Tax Reform Act, working with summary descriptions of the two bills, adopted, generally, the Senate version. This action was reported by a Joint Committee on Taxation summary of August 16, 1986 which stated, in pertinent part, "Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on identification of income and flow-through of income character and with technical modifications." On August 29, 1986, the Joint Conference Agreement (JCS-16-86), stated, in pertinent part, "Present law is amended to require either payment of an interest charge on eventual recognition of income earned by U.S. investors through _passive FICs_ (subject to a gain limitation) or current recognition, and to apply these rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. . . ." (Emphasis supplied.)

Neither release revealed that the language of the PFIC provisions of the Senate bill had been so thoroughly--and we believe erroneously--redrafted as to effectively end deferral for many CFCs. The Conference Report on the Tax Reform Act of 1986, consisting of statutory language and an explanation (H.Rept. 99-841), was released on September 18. The measure was passed by the House on September 25 and the Senate on September 27.

Tax Reform Act.--As passed, TRA contained substantial errors, many of which are still being identified. We do not believe that Congress knew, or was able to know, that the PFIC rules contained in the bill would apply to U.S. shareholders of CFCs and would have the effect of ending deferral for many CFCs.

The Institute firmly believes that the Subpart F regime should be retained. Enacted in 1962 and modified several times since, it is an effective, generally balanced mechanism for taxing U.S. shareholders on income related to foreign subsidiary operations. Part of its balance lies in the distinction it draws between passive, tax haven-type income and operating income, should be retained. It is a balance which Congress, on addressing the issue directly, has chosen not to disturb./5 Congress could have, and did not, take up the issue of ending deferral in considering the CFC provisions included in TRA. Moreover, taxpayers did not have the opportunity to comment on provisions which fundamentally change the long-standing mechanisms governing U.S. taxation of CFC operations prior to enactment of those rules.

If the Subpart F regime is to be modified, Congress should have the opportunity to confront head on the issues such action would entail. Congress has not had that opportunity in connection with the PFIC provision as extended to CFCs. This, in our view, is an error which occurred as part of the TRA drafting process and, thus, its correction warrants inclusion in TCA.

Valuation for Purposes of Assets Test of Section 1296(a)(2) Should Be Defined

Most CFCs which would be PFICs by virtue of the income test, which has a 75 percent passive income threshold, would also be subject to the 70 percent full inclusion rule of Subpart F./6 By contrast, many CFCs with substantial non-Subpart F income may be subject to the PFIC rules if "the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income . . . is at least 50 percent." (Section 1296(a)(2)) The test is not further defined in the statute or in the legislative history. Similarly, TCA, as introduced, would provide no further elaboration.

In the context of an investment fund, the assets test may be fairly easy to apply because such a fund's assets would consist largely of cash, securities, and their equivalents. In the context of an operating company, however, valuation is far more complex. The statute does not indicate whether fair market value, book value, or net book value applies. No guidance is given regarding the treatment of assets such as trade receivables, manufacturing intangibles, "going concern" value, goodwill, contracts, and the like. This raises the specter of unreasonable uncertainty. Further, it offers the Internal Revenue Service wide-ranging opportunity to sweep many CFCs which have substantial operating income into the PFIC net.

5/ In connection with the Tax Reform Act of 1976, the Carter Administration proposed eliminating deferral with respect to non-Subpart F income. The proposal was not adopted by Congress.

6/ The income which enters into the 75 percent PFIC income test and that which enters into the 70 percent Subpart F test differ in several respects, although the key common element is foreign personal holding company income.

TCA Section 112(n) Reflects Congressional Intent Except to the Extent That It Would Not Exclude U.S. Shareholders of CFCs From the PFIC Provisions

TCA Section 112(n) would modify the PFIC provisions in several respects which, in our view, are consistent with the provisions' legislative purposes. In particular, the section includes two crucial amendments. Section 112(n)(7) would repeal Section 1296(a)(5) which denies the Section 902 deemed paid credit to PFICs which are not QEFs. Section 112(n)(3) would require excess distributions to be properly adjusted for income previously included in gross income by virtue of Subpart F, the foreign personal holding company rules, and the QEF rules.

These amendments would limit the double taxation that almost certainly will result from the application of the PFIC provisions to CFCs. They are not, however, sufficient to cure the totally inappropriate imposition of PFIC taxation on U.S. multinationals that are U.S. shareholders of CFCs, which have substantial operating income or which are holding companies for second (or lower) tier operating subsidiaries. As we have urged above, the Subpart F tax regime ensures that any significant amounts of passive income generated by such companies are taxable currently at the U.S. shareholder's level. When confronted with the issue of ending deferral with respect to CFC operating income, Congress has chosen to retain it. Injudicious drafting of provisions not directed at operating CFCs should not change this result.

Conclusion

Considerable congressional attention has been given to the issue of the competitiveness of American business in global markets. One obvious element of competitiveness is cost. And, one element of cost is taxes. To the extent U.S. multinational businesses bear greater aggregate burdens of taxation than do similiarly situated foreign multinationals, their ability to compete is compromised.

The Code's CFC provisions represent, in part, an effort to level the playing field. U.S. shareholders are taxed on their investments in CFC operations only when they earn certain types of income (generally passive and moveable in nature) or when they receive a return on their investments in the form of dividend payments or gain on disposition. This is as it ought to be.

The PFIC provisions, incorrectly and we think unintentionally, slant the playing field by effectively eliminating or penalizing deferral and Congress has not had the opportunity to confront the issue of whether this serves this country's trade or tax policy interests. An effort to plug an investment fund leak may sink the reliable, well-tuned approach to taxing U.S. multinationals' CFC operations.

We hope that our comments will prove useful in the Committee's consideration of TCA. Should there be any questions or if we can be of assistance, please contact us.

LYNN MARTIN
16TH DISTRICT, ILLINOIS

HOUSE ARMED SERVICES COMMITTEE

VICE CHAIRMAN
REPUBLICAN CONFERENCE

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House of Representatives
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August 4, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth H.O.B.
Washington, D.C. 20515

Dear Dan:

Recently I was contacted by Mr. Ted Ross, Vice-President of Sundstrand Corporation, a major corporation in Rockford, Illinois. Sundstrand Corporation is extremely concerned with the PFIC rules included in the 1986 Tax Reform Act which, if not corrected, will severely limit Sundstrand's capability to compete in the international arena.

Enclosed is a proposed technical amendment to the 1986 Act which would exclude foreign operating subsidiaries of U.S. multinational companies from the Passive Foreign Investment Company (PFIC) provisions. I strongly urge you to consider this proposal as you finalize the Technical Corrections Act of 1987.

Thank you for your consideration of this matter, and I look forward to your response.

Sincerely,

Lynn

LYNN MARTIN
Member of Congress

Sundstrand Corporation

SUNDSTRAND

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JUL 23 1987

July 21, 1987

The Honorable Lynn M. Martin
1208 Longworth House Office Building
Washington, DC 20515

RE: Technical Corrections Act of 1987 -
Passive Foreign Investment Company Provisions

Dear Congresswoman Martin:

I am writing to you concerning an oversight in the 1986 Tax Reform Act which, if not corrected in the Technical Corrections Act, will have a profound effect on Sundstrand Corporation's ability to compete effectively in foreign markets. The correction I propose is truly technical--there is no revenue loss involved.

The 1986 Act contained certain provisions directed at a few well-placed U.S. individuals who were able to avoid the anti-abuse provisions of the Subpart F rules, foreign personal holding company rules, and other similar rules, by making investments in carefully designed offshore mutual funds. Both the House and Senate versions of the Tax Reform Act contained provisions directed to end this abuse on the part of U.S. investors in these "passive foreign investment companies" ("PFICs").

I have enclosed three items dealing with this problem. The first is an in-depth memorandum on the legislative background and need for the technical amendment; the second is a two-page Executive Summary of the chief points in the memorandum; and the third contains suggested language for a technical amendment.

As demonstrated in the in-depth memorandum, an analysis of the legislative history shows that the special "PFIC rules" were never intended by Congress to apply to foreign operating subsidiaries of United States companies. As you are no doubt aware, such subsidiaries are already fully covered by the anti-abuse rules of Subpart F, so that all of their passive investment income is already subjected to current U.S. taxation. In fact, the Senate version of the PFIC rules expressly excluded such operating subsidiaries from their reach, and the House version reached the same result.

It was most surprising, then, that the final statute as drafted did not contain such an exclusion, even though the Conference Agreement, issued August 16, 1987, stated that the Conference had followed the Senate bill with respect to the PFIC rules.

Sundstrand Corporation is a market leader in the design, manufacture, and sale of a variety of proprietary, technology-based components and subsystems requiring significant research, development engineering, and processing expertise. Our mechanical, hydromechanical, electromechanical, and electronic products serve diversified aerospace and industrial markets. In order to compete in the worldwide markets, we have established several foreign subsidiaries. Obviously, such operating subsidiaries are not "offshore mutual funds" and were not targeted as an abuse by the PFIC provisions. But without an exclusion from the PFIC rules of the type contained in the Senate and the House bills, we have discovered that the PFIC rules may well apply to one or more of our foreign operating subsidiaries. This would result in a complete change in the long-established regime for taxing the earnings of foreign operating subsidiaries of U.S. businesses.

Accordingly, I believe that the Technical Corrections Act of 1987 should contain an appropriate technical correction to recognize that such foreign operating subsidiaries and their U.S. parent corporations were not intended to be covered by the PFIC rules. Failure to make such a correction will have important, and I believe entirely unintended, negative consequences on Sundstrand's international competitiveness.

I urge you to examine carefully the enclosed materials. I am certain that once you and your staff have done so, you will conclude that such a technical correction is needed, and will support its inclusion in the Technical Corrections Act.

Please note that, because a true oversight appears to have occurred in the final drafting process, there is no revenue loss from adopting the proposed amendment. The proposed amendment contains the statutory language in the Senate bill omitted from the final version. Both the Senate Report and the Conference Report contain the same revenue estimate. This again indicates the technical nature of the proposal; if the omission had been intentional, not only would it have been discussed, but revenue would have been assigned to it.

Please do not hesitate to contact me should you have any questions. You may also contact Thomas O'Donnell or Dennis Meyer of Baker & McKenzie in Washington (298-8290), who are representing us in this matter.

Sincerely yours,

SUNDSTRAND CORPORATION

Ted Ross

Ted Ross
Vice President
Finance and Secretary

PROPOSED TECHNICAL AMENDMENT TO EXCLUDE U.S. SHAREHOLDERS OF CONTROLLED FOREIGN CORPORATIONS FROM THE APPLICATION OF THE RULES FOR PASSIVE FOREIGN INVESTMENT COMPANIES

Add the following new paragraph at the end of section 112(n):

> (25) Subsection (b) of section 1297 of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> "(9) EXCEPTION WHERE SECTION 951 APPLIES.--This part shall not apply to a taxpayer with respect to a corporation if, without regard to this Part--
>
> "(i) such corporation is a controlled foreign corporation (as defined in section 957), and
>
> "(ii) the taxpayer is a United States shareholder (as defined in section 951(b)) with respect to such corporation."

EXECUTIVE SUMMARY OF MEMORANDUM IN SUPPORT OF PROPOSED TECHNICAL AMENDMENT TO THE PFIC PROVISIONS

Submitted by

The Coalition to Exclude Operating Income
From the PFIC Provisions

- **PFIC rules of IRC §§ 1291-1297, as now written, apply to foreign operating subsidiaries of U.S. multinationals.**

- **Congress never intended PFIC rules to apply to foreign operating subsidiaries of U.S. multinationals.**

  The PFIC rules were aimed at passive income earned through offshore mutual funds in ways carefully structured to avoid anti-abuse rules already in place, such as Subpart F.

Foreign operating subsidiaries are fully covered by the Subpart F rules on any passive income, so no such abuse is possible.

The House bill corrected the abuse by making all shareholders of offshore funds subject to Subpart F rules, regardless of status as "U.S. shareholders."

The Senate bill created special rules for taxation of PFICs, but specifically excluded "United States shareholders" of "controlled foreign corporations" from the application of such rules, because they were already covered by Subpart F rules.

- The Conference Agreement of August 16 adopted the Senate Bill with only "technical modifications."

  Accordingly, U.S. shareholders of CFCs should have been excluded from PFIC rules.

- Final statute omitted the exclusion of U.S. shareholders of CFCs without explanation.
- No hint anywhere in legislative history that U.S. shareholders of CFCs were to be covered by PFIC rules.
- No hint anywhere in legislative history that deferral treatment for non-Subpart F operating income was to be eliminated.
- Both Senate and House agreed that Subpart F rules were full protection against abuse, and U.S. shareholders of CFCs are fully subject to such rules.
- The asset test for PFIC status will unintentionally cause many foreign operating subsidiaries of U.S. multinationals to be treated as PFICs.
- Failure to correct oversight would constitute a major reversal of U.S. tax policy with respect to foreign operating subsidiaries of U.S. multinationals.
- Failure to correct would have major negative effect on ability of U.S. to compete in overseas markets.
- The proposed amendment has no revenue impact.

  The revenue estimates from the PFIC rules were $82 million over five years in both the Senate Report and the Conference Report, and $85 million over five years in the House Report.

  The Senate bill excluded U.S. shareholders of CFCs from the PFIC rules, as did the House bill.

  Thus, by adopting the proposed amendment, which merely adds back the Senate bill's exclusion, no revenue will be lost over that projected in the original bill.

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MEMORANDUM

PROPOSED TECHNICAL AMENDMENT
TO EXCLUDE OPERATING INCOME
OF FOREIGN OPERATING SUBSIDIARIES
OF U.S. COMPANIES FROM
THE PASSIVE FOREIGN INVESTMENT COMPANY PROVISIONS

prepared by

The Coalition to Exclude Operating Income
From the PFIC Provisions

The Coalition to Exclude Operating Income from the PFIC Provisions consists of United States-based corporations competing in overseas markets. The Coalition was organized because the Passive Foreign Investment Company ("PFIC") provisions enacted as section 1235 of the Tax Reform Act of 1986 (codified as sections 1291-1297 1/) would apparently classify many of their foreign operating subsidiaries as PFICs. Such classification would subject them to current U.S. taxation on the operating income of their foreign subsidiaries. The Coalition believes such a result is a technical oversight in the Tax Reform Act, and was clearly not intended by Congress.

The Coalition is fully supportive of the amendments to the PFIC provisions contained in section 112(n) of the Technical Corrections Act("TCA"). However, such proposed amendments do not address the Tax Reform Act's failure to exclude U.S. shareholders of controlled foreign corporations ("CFCs"), who are already subject to current U.S. taxation of passive income earned by their CFCs, from the PFIC provisions. The Coalition believes that the application of the PFIC rules to U.S. shareholders of CFCs was not intended by Congress.

As demonstrated more fully below, neither the House nor

1/ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986.

the Senate provisions dealing with PFICs affected the taxation of U.S. shareholders (as defined in section 951(b)) of CFCs (as defined in section 957). In addition, the Conference Agreement, as summarized in August 1986, did not indicate that this aspect of the PFIC provisions had been altered in any way by the Conferees. However, the final version of the statutory PFIC provisions failed to exclude such U.S. shareholders of CFCs, notwithstanding the fact that they were already subject to current U.S. taxation on all of the categories of passive investment income covered by the PFIC provisions.

A. The House Bill.

The House was concerned generally that certain well-placed individuals could invest in offshore mutual funds holding passive assets in a manner that allowed them to defer taxation on current income of the funds and to repatriate such income at favorable capital gains rates. The Subpart F, personal holding company, and foreign personal holding company provisions, designed to require current inclusion of passive income, could be avoided by keeping U.S. owners as a minority of the shareholders of the offshore fund. Further, the foreign investment company provisions of section 1246, designed to require ordinary income treatment on gains from the sale of offshore mutual fund stock, could be avoided by keeping U.S. ownership of the investment fund at half or less and by limiting the total number of U.S. persons investing in the fund to fewer than 100. Because of these various limitations, this loophole was available only to a few well-placed Americans. The House thought this loophole was unfair, and closed it. 2/

The House Bill accomplished this by defining certain foreign corporations as PFICs, using the same passive income

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2/ H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985).

or passive asset test as was eventually enacted in section 1296. It then treated all PFICs and their shareholders as CFCs fully subject to Subpart F, regardless of the proportion of U.S. ownership or the percentage of stock held by a particular U.S. person. Further, the House Bill also subjected offshore mutual funds to the ordinary income recharacterization rules of section 1246 regardless of the level of U.S. ownership. The result was that U.S. investors in offshore mutual funds would be currently taxable on the fund's income, all of which would normally be passive, and would be taxed at ordinary rates on any gain from the sale or redemption of shares in such a fund.

Because the House Bill addressed the problem by expanding the definition of "U.S. shareholder" and "CFC," it had no impact on those taxpayers who were already U.S. shareholders of CFCs. Consequently, under the House Bill, the normal rules for taxation of income earned through foreign subsidiaries, contained in the Subpart F provisions of the Code, would have continued to apply to such U.S. shareholders.

The House Bill and its legislative history contained no hint that the normal rules for taxing U.S. shareholders were to be altered. Stated differently, the House Bill never contemplated or suggested that the PFIC rules should have the effect of causing the current inclusion of income of a CFC in its U.S. shareholder's income where such CFC income was operating income not subject to the current inclusion rules of Subpart F.

Significantly, the revenue estimate for the House Bill's provision was only $85 million over five years, thus clearly signifying the limited nature of the loophole being closed.

B. The Senate Bill.

The Senate Bill also closed the loophole identified by the House Bill, and for the same reasons, but did so in a substantially different manner. Nevertheless, it retained the House Bill's definition of a PFIC, and subjected holders of PFIC stock to a regime of taxation similar to that appearing in the PFIC provisions as finally enacted.

Most importantly, however, the Senate Bill specifically excluded U.S. shareholders of CFCs from the application of the PFIC provisions, apparently on the theory (obviously accurate) that such U.S. shareholders were already subject to current U.S. taxation on any passive income earned by their CFCs, and ordinary income treatment (via the gain recharacterization rules of section 1248) on any gain from a disposition of CFC stock. 3/

Moreover, the Senate Bill permitted any taxpayer otherwise subject to the PFIC rules to elect to be treated as a U.S. shareholder of a CFC, so that Subpart F, and not the PFIC provisions, applied. As was the case in the House, there was no hint of any intent to subject U.S. shareholders of CFCs to current taxation on the operating income earned by their CFCs. To the contrary, the election to be treated under Subpart F rather than the PFIC rules, which was available to all U.S. persons who were not U.S. shareholders in CFCs, constituted an affirmative recognition by the Senate that such income need not be subject to current inclusion.

Again indicating the limited nature of the loophole being closed, the Senate estimated that the total revenue pickup from the PFIC provisions would be $82 million over a five-year period.

C. The House and Senate Bill Compared.

A comparison of the PFIC provisions in both the House and Senate Bills reveals two important conclusions: First,

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3/ H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill). S. Rep. No. 313, 99th Cong., 2d Sess. 397 (1986).

both chambers agreed that the PFIC provisions should not affect the taxation of U.S. shareholders of CFCs. Second, both chambers agreed that the application of the Subpart F rules was a complete remedy for the loophole identified. On this latter point, the House signified this intent by actually placing PFICs and their shareholders under the Subpart F rules, while the Senate did so by making Subpart F an alternative at the option of the taxpayer.

From this, it is clear that it was never the intent of either the House or the Senate to subject U.S. shareholders of CFCs to current U.S. taxation or a deferred interest charge on the operating income of their CFCs under the PFIC rules.

D. The Conference Agreement of August 16, 1986.

When the House-Senate conferees met to resolve differences between the two versions of the tax reform bill, they had only the texts of the House and Senate bills to consider. In arriving at the final bill, they did not consider statutory language, but rather were presented with short summaries of possible compromises by the various staffs, i.e., House Ways & Means Committee staff, Senate Finance Committee staff, and Joint Committee on Taxation staff. As far as we are aware, none of these summaries suggested that U.S. shareholders of CFCs be made subject to the PFIC provisions.

On August 16, 1987, the staff of the Joint Committee on Taxation issued, at 8:30 P.M., a summary of the final agreement by the House-Senate conferees on the tax reform provisions (the "August 16 Summary"). It is this document which was the basis for the formal Conference approval of the Tax Reform Act that occurred later that same evening.

The full text of the August 16 Summary with respect to the PFIC provisions was as follows:

> 8. **Foreign investment companies**
>
> **Tentative agreement.**--Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on the identification of income character and with technical amendments.

August 16 Summary at 61.

This short statement indicates that the provision in the Senate Bill exempting U.S. shareholders of CFCs from the application of the PFIC rules was retained in the final Conference Agreement. The elimination of such exemption is not specifically mentioned, and such elimination, which would greatly expand the scope of the PFIC rules, cannot reasonably be called a "technical amendment."

Two weeks later, on August 29, 1986, the staff of the Joint Committee on Taxation published a more formal summary of the Conference Agreement ("August 29 Summary"). 4/ In its entirety, this new summary described the Conference Agreement as follows:

> 6. Foreign Investment Companies (FICs)
>
> Present law is amended to require either payment of an interest charge on eventual recognition of income earned by U.S. investors through passive FICs (subject to a gain limitation) or current recognition, and to apply these rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. This provision is effective for taxable years beginning after 1986.

August 29 Summary at 61.

As with the August 16 Summary, there is no hint that the PFIC provisions would subject U.S. shareholders of CFCs to current taxation or a deferred interest charge on operating income of CFCs.

4/ Staff, Joint Committee on Taxation, Summary of Conference Agreement on H.R. 3838 (Tax Reform Act of 1986) (JCS-16-86) (August 29, 1986).

E. The Final Statute.

The statutory language of the Tax Reform Act of 1986 was not released to Congress until September 18, 1986. It was over 900 pages long, and contained substantial errors, both technical and substantive. Nevertheless, the House passed the Act on September 25th, and the Senate on September 27th; no corrections were made to deal with the errors. Indeed, it was manifestly impossible, in such a short time, to identify and correct all the errors in so massive a piece of legislation.

The PFIC provisions of the Act had been substantially redrafted when compared to the Senate Bill's provisions. Importantly, the provision contained in the Senate Bill exempting U.S. shareholders of CFCs was omitted.

The Conference Report, published simultaneously with the Act, gives no hint that U.S. shareholders of CFCs would be subject to the PFIC provisions. In fact, it discusses the provision solely in the context of passive offshore investment funds. The major effect of the Act's PFIC provisions is to eliminate the benefit of deferral from current taxation of income earned by a PFIC. 5/ In this regard, the Conference Report states that these provisions were aimed exclusively at offshore investment funds:

> The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.

H.R. Rep. No. 841, 99th Cong., 2d Sess. II-641 (1986).

The Conference Report also states that: "The conferees do not intend that foreign corporations owning the stock of subsidiaries engaged in active businesses be classified as PFICs." *Id.* at II-644. This further indicates that foreign

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5/ The benefit of getting capital gains treatment on disposition of stock in a foreign investment fund was, of course, eliminated by the repeal of the capital gains/ordinary income rate differential.

subsidiaries that are directly engaged in active businesses were never considered by Congress to be subject to PFIC treatment. Nevertheless, as described below, the omission from the Act of the Senate Bill provision exempting U.S. shareholders of CFCs will have that result unless the omission is corrected.

F. Congressional Approval of Deferral--Subpart F.

Subpart F was passed in 1962 so as to eliminate the use of foreign subsidiaries to obtain deferral of U.S. tax, where such subsidiaries were engaged in specified "tax haven"-type activities or earned specified "tax haven"-type income. Since 1962, Subpart F has served to guard against the use of a foreign corporation to obtain deferral of U.S. tax with respect to types of activities or income that Congress believed should be subject to current U.S. tax. In this regard, Congress has refined the definition of "Subpart F income," i.e., income subject to current inclusion in the U.S. shareholder's income under the rules of Subpart F, over the years, most recently in the Tax Reform Act of 1986, to assure that U.S. shareholders cannot use CFCs to gain the benefit of deferral on passive investment income and carefully defined categories of foreign base company income.

Importantly, however, Congress has always permitted deferral of U.S. taxation on operating income not included in the definition of Subpart F income. In both 1962 and 1976, Congress was presented with the option of eliminating deferral on all income of foreign subsidiaries regardless of its type, and it considered the matter on an in-depth basis both times. Both times it rejected the elimination of deferral with respect to operating income generally as being against the interests of the United States in promoting the international competitiveness of United States business.

6/ Notably, these safeguards include requiring current inclusion of all of a CFC's income in the taxable income of its U.S. shareholders where the CFC is used primarily (but not exclusively) to earn tax haven-type income, that is, where more than 70 percent of the CFC's gross income is tax-haven-type income. § 954(b)(3)(B).

The evolution of Subpart F represents the direct and cumulative judgment of Congress as to what types of income should be subject to current U.S. tax when earned by foreign subsidiaries of U.S.-based multinational corporations. 6/ Indeed, in light of this background, it is not surprising that neither the House nor the Senate bills, in their PFIC provisions, would have affected U.S. shareholders of CFCs who were already covered by the Subpart F provisions. It is surprising, however, that the Conference bill would effectively reverse the long-standing Congressional judgment that operating income of CFCs generally should not be taxed currently to their U.S. shareholders.

G. The Effect of the Asset Test on Operating Companies.

Unfortunately, the PFIC provisions as enacted, if not corrected, would effectively override Congress's judgment that non-Subpart F income should be eligible for the benefit of deferral. In effect, the PFIC provisions would swallow up the careful distinctions made by Subpart F, subjecting all income of CFCs, regardless of type, to the economic equivalent of current U.S. taxation. For instance, a wholly owned foreign manufacturing subsidiary of a U.S. corporation could quickly become a PFIC because of its accumulation of assets not directly used in its day-to-day business. This result occurs because of the mechanical operation of the asset test, when unchecked by an exemption for U.S. shareholders of CFCs. 7/

Under the asset test, any foreign corporation is a PFIC if half or more of the average value of its assets consists of assets producing passive income or assets held for the production of passive income. Thus, if an active CFC

7/ Notably, the passive income test does not pose a problem for a CFC. As noted, if more than 70 percent of its gross income is passive, all of the CFC's income is subject to current inclusion in the U.S. shareholder's taxable income under the Subpart F rules. This percentage is less than the 75 percent passive income threshhold for application of the PFIC provisions.

accumulates profits with a view to further expansion of its operations, it could quickly find itself a PFIC if its operations are particularly profitable. Further, certain assets, such as trade accounts receivable, often account for a substantial portion of the "asset" value of a CFC, and such assets might well be classified as passive assets under the PFIC rules. 8/ Similarly, manufacturing facilities which are temporarily closed, real estate purchased with a view towards construction of new manufacturing facilities in the future, and the like, could result in PFIC status for a CFC which is in an active business.

Without the exemption for U.S. shareholders in CFCs from the PFIC provisions, a great many active foreign business operations would be potentially subject to the PFIC rules, despite the fact that the vast majority of their income was non-tax haven-type income. Clearly, foreign operating subsidiaries of U.S. corporations are not offshore investment funds of the type that concerned Congress in enacting the PFIC provisions, and Congress could not have intended to subject them to the PFIC rules.

If Congress had intended to end deferral on non-Subpart F income, Congress would have faced the issue head on, and done so by modifying the Subpart F provisions. As shown above, however, Congress has refused to take this step every time that it has been faced squarely with the issue.

B. Status as Technical Amendment.

As demonstrated above, neither the House nor the Senate ever indicated any intention that U.S. shareholders of CFCs be subject to the PFIC rules. Rather, they consistently indicated that Subpart F was the exclusive and adequate

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8/ See section 954(c) (defining non-income-producing assets as "passive" assets).

safeguard against tax abuse in such situations. The Conference Agreement, as expressed in August, clearly envisions the incorporation of the provisions of the Senate Bill in the final Act, and this must have included an intent to retain the exclusion from the PFIC rules found in the Senate Bill, in view of the fact that there was no difference between the House and Senate Bills on this point.

Subpart F has for twenty-five years expressed Congress's considered policy judgment with regard to the proper taxation of U.S. shareholders of CFCs. This was recognized by both the House and Senate Bills. A major reversal of this policy is nowhere hinted at in the legislative history of the PFIC provisions. Rather, that history, fairly read, indicates that those provisions are directed solely at taxation of passive income earned through offshore mutual funds and similar types of passive investment vehicles.

It is simply incomprehensible that such a major change in the tax regime governing U.S. shareholders of CFCs could have occurred intentionally without some discussion or some hint that Congress so intended. Rather, it seems obvious that the omission of the provision in the Senate Bill exempting U.S. shareholders of CFCs from the PFIC provisions was a technical "glitch."

Further evidence that this omission was unintentional may be gleaned from the fact that the revenue estimate appearing in the Conference Report was only $82 million over a five-year period--exactly the same estimate as contained in the Senate Finance Committee Report. The expansion of the PFIC rules to cover the operating income of foreign operating subsidiaries, as compared to the Senate or House Bills, would clearly result in substantially higher revenues. Consequently, it seems obvious that the only intended target of the PFIC provisions was the original loophole identified by the House.

I. The Proposed Amendment.

Accordingly, the Coalition submits that the following amendment to section 112(n) of the Technical Corrections Act should be added to that Act: [9]

> (25) Subsection (b) of section 1297 of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> "(9) EXCEPTION WHERE SECTION 951 APPLIES.--This part shall not apply to a taxpayer with respect to a corporation if, without regard to this Part--
>
> "(i) such corporation is a controlled foreign corporation (as defined in section 957), and
>
> "(ii) the taxpayer is a United States shareholder (as defined in section 951(b)) with respect to such corporation."

As noted, this amendment is copied from the Senate bill provision, and, accordingly, would achieve the intent of Congress with respect to U.S. shareholders of CFCs.

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[9] This amendment is identical to the exclusion in the Senate Bill, H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill), with the exception that the term "Part" has been substituted for "section" to reflect the PFIC provisions as enacted.

Comments
of
TAX EXECUTIVES INSTITUTE, INC.
on
The Passive Foreign Investment Company Provisions of the Tax Reform Act of 1986

August 28, 1987

This submission sets forth Tax Executives Institute's concerns relating to the passive foreign investment company (PFIC) provisions of the Tax Reform Act of 1986. As enacted, the PFIC provisions differ materially from the provisions contained in the House and Senate version of the 1986 Act. As a result, neither Congress, nor the Treasury Department, nor -- most importantly -- taxpayers -- had an opportunity to analyze the technical soundness of the provisions before the fact.

The consequence, in our view, was the enactment of a technically unsound statute. Perhaps more fundamentally, the PFIC provisions effect profound changes in the way the United States taxes the international operations of U.S. controlled foreign corporations (CFCs) -- changes that we submit would well not have been made had adequate time been allowed for debate and analysis.

Our comments are divided into three parts: first, we discuss the interplay of Subpart F and the PFIC provisions; secondly, we address definitional issues raised by the PFIC provisions; and thirdly, we address certain miscellaneous issues raised by the provisions.

I. Background

Tax Executives Institute is the principal association of corporate tax executives in North America. Our approximately 4,000 members represent more than 2,000 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the costs and burdens of administration and compliance to the benefit of taxpayers and government alike.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax laws relating to the operation of business enterprises. We believe that our diversity and the professional training of our members enable us to bring an important, balanced, and practical perspective to the issues raised by the enactment of the PFIC provisions of the Code: we are the ones who have to deal with the provisions on a day-to-day basis.

II. Overview of the PFIC Provisions

The PFIC provisions are contained in sections 1291 through 1297 of the Internal Revenue Code. Section 1296 defines a PFIC as any foreign corporation if 75 percent or more of its gross income for a taxable year consists of passive income or if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. The PFIC provisions set forth rules for (i) the taxation of U.S. shareholders on distributions from PFICs and the gain from the disposition of PFIC stock if the PFIC is not a qualified electing fund (QEF), and (ii) the taxation of U.S. shareholders on the income of PFICs that are QEFs.

For both non-electing funds and QEFs, the PFIC provisions operate to effectively eliminate deferral on income derived by the PFIC. In the case of a non-electing fund, the U.S. shareholders in a PFIC are required to pay tax on distributions or on the gain on dispositions of PFIC stock as though these amounts were recognized over the period during which the shareholder held the PFIC stock. In the case of a QEF, deferral is eliminated via current taxation of the PFIC earnings (subject to an election to defer the current payment of tax if an interest charge is borne on the deferred tax).

A non-QEF's "excess distributions" are recognized over the shareholder's holding period of PFIC stock. The term "total excess distribution" is defined by section 1291(b)(2) as that portion of the distribution in excess of 125 percent of the average distribution in the three preceding years. A deferred tax amount is added to the excess distribution allocated over the holding period; the amount of the tax is computed by calculating tax at the highest ordinary rate for each of the years during the holding period, and interest (under section 6621) is then added for each (post-1986) year that the corporation was a PFIC.

In addition, the PFIC provisions require the taxpayer to pay the current year tax on the non-excess distribution plus tax on any amount allocated to a year that the corporation was not a PFIC (no interest is charged on non-PFIC years). This calculation applies without regard to whether the PFIC would qualify as a CFC or Foreign Personal Holding Company (FPHC).

III. Interplay of Subpart F and PFIC Provisions

TEI is very concerned about the interplay between Subpart F and the PFIC provisions. As enacted, the PFIC statute contains serious technical problems. Furthermore, in operation we believe the PFIC provisions potentially do much more than what they were intended to do -- to fill certain gaps in the Subpart F and FPHC provisions of the Code.

The Subpart F and FPHC provisions do not apply where ownership of a corporation is either majority-held by non-U.S. taxpayers or widely dispersed so that U.S. taxpayers own less than 10 percent of the corporation. TEI submits that CFCs that are subject to the provisions of Subpart F should not be subject to the PFIC rules, even if Subpart F is not operative on all or a part of their income. In other words, the Subpart F tests are quite adequate to satisfy congressional concerns about CFCs and a CFC should not have to "pass" both the Subpart F and the PFIC tests.

The language of the statute, particularly section 951(f), makes it clear that Congress intended for the PFIC provisions to supplement Subpart F and that, if both were applicable, Subpart F should be applied to the exclusion of the PFIC rules. The PFIC provisions, however, go beyond that intent and, unless legislatively corrected, will produce double taxation of U.S. shareholders in a PFIC and denial of appropriate deemed-paid foreign tax credits.

As set forth in detail below, Tax Executives Institute believes that the Code's CFC rules and the PFIC provisions should be mutually exclusive and strongly recommends that corrective legislation be immediately enacted.

1. Previously Taxed Income and Deemed Credits

TEI is encouraged that technical corrections have been proposed to mandate adjustments for non-QEFs to avoid taxation under the PFIC provisions of income previously taxed pursuant to Subpart F, and to permit section 902 deemed-paid credits. Section 112(n)(3) of the Technical Corrections Act of 1987 provides, in part, that under regulations proper adjustment shall be made for amounts not includible in gross income by reason of section 959(a), and section 112(n)(7) deletes the statutory provision that would deny deemed paid credits to non-electing fund shareholders.*

The Staff of the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 states (at page 1033) that --

> "it was intended that if income is included currently by a U.S. person under the Subpart F provisions and the foreign corporation is also a PFIC which is not a qualified electing fund, the amounts previously included in income should not also be subject to the Act's interest charge rules on subsequent receipt of an excess distribution or on subsequent disposition of stock."

The General Explanation notes that a technical correction may be necessary for the statute to reflect this intent. The rationale for this exclusion from the interest charge is that Subpart F has already taxed the income thereby making the value of deferral nonexistent. Equally as logical, since the income has already been taxed, no deferred tax amount should be required. The Technical Corrections Act of 1987 mandates this result.

Although the pending Technical Corrections Bill addresses the previously taxed income and deemed paid credit issues, a number of other issues remain under the PFIC provisions. These issues, which arise primarily because of the statute's failure to mesh the PFIC rules with the Subpart F and FPHC rules, include the inadvertent taxation of foreign operating income by the PFIC provisions as well as a number of definitional problems. Our comments, which are not all-inclusive, describe the issues and propose technical corrections to resolve them.

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* We note that even without the technical corrections a taxpayer could retain section 902 credits and not be subject to a deferred tax amount if a QEF election were made. However, under the QEF election, U.S. shareholders would be taxed currently on all earnings and profits of the foreign subsidiary including earnings that would otherwise be deferred (i.e., manufacturing income). Therefore, we do not believe that the QEF election is a practical alternative by which double taxation could be avoided and foreign tax credits retained.

2. Section 954(b)(4) Income

One issue that is not addressed by the pending Technical Corrections Bill relates to a CFC that will constitute a PFIC even though it would be subject to current tax under Subpart F but for section 954(b). For example, interest income derived by a CFC in the active conduct of a finance business constitutes "passive income" for purposes of the PFIC rules. These earnings will not be subject to taxation under Subpart F, however, if the income is subject to an effective rate of income tax imposed by the foreign country greater than 90 percent of the maximum rate of tax specified in section 11. (I.R.C. Sec. 954(b)(4).)

When foreign earnings are being taxed at more than 90 percent of the maximum U.S. tax rate, it cannot be said that the investor is avoiding "the economic equivalent of current taxation" (see the General Explanation at page 1023). Thus, there is no need to apply the PFIC rules, and appropriate technical corrections should be adopted to exclude such situations from the operation of the PFIC rules.

3. Taxation of Operating Income

As described above, U.S. shareholders in a PFIC are required to pay tax on excess distributions or gain on dispositions of stock as if those amounts had been recognized ratably over the shareholder's holding period for the stock. By contrast, U.S. shareholders in a PFIC that has made a QEF election are required to include in income their pro-rata shares of the PFIC's current earnings and profits regardless of whether an actual distribution is received. Under either approach, the advantage of tax deferral on passive income is eliminated.

We understand Congress's desire to fill gaps in the Subpart F and FPHC provisions, thereby taxing passive income more effectively. We believe, however, that the reach of the

PFIC rules is excessive in that they may, unless corrected, result in taxation of not only passive income but also operating income of foreign corporations.

This is because a foreign manufacturing subsidiary will be considered a PFIC when the value of passive-income-producing assets in which retained profits are invested equals or exceeds the value of operating assets (plant, equipment, etc.). Many U.S. corporations that conduct overseas manufacturing through CFCs, however, typically accumulate substantial reserves, sometimes in excess of the value of their existing operating assets, in anticipation of expansion.

Thus, after the 1986 Act, CFCs engaged in manufacturing that retain passive assets may well be PFICs and distributions (of not only passive income but also operating income) by the PFIC to its parent will be subject to allocation under the excess distributions rule of section 1291(a). To the extent that such distributions comprise amounts previously taxed under Subpart F (i.e., passive income), they will (under the proposed Technical Corrections Act) be excluded from the parent's income. However, the parent is nonetheless subject to PFIC tax, including the interest charge for all post-1986 years that the subsidiary was a PFIC, on amounts attributable to the subsidiary's non-Subpart F manufacturing income.*

In our view, the impropriety of this result cannot be overstated: it is wrong both in view of Congress's intent in enacting the PFIC rules and in light of the longstanding policy of not taxing U.S. shareholders of CFCs on the foreign manufacturing income of those CFCs.

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* Under pre-1986 law, the U.S. parent was subject to the rules of Subpart F only with respect to passive income earned by its CFCs. This treatment of passive income is continued under the 1986 Act's tightened Subpart F provisions. In addition, the proposed Technical Corrections Bill would accord Subpart F priority with respect to such passive income in the case of a CFC that is also a PFIC.

The legislative history of the Tax Reform Act of 1986 contains nothing suggesting that the PFIC provisions were intended to penalize U.S. shareholders in CFCs. Indeed, that history plainly shows that the purpose of the PFIC provisions is to discourage individual investors from using foreign companies as a device for avoiding U.S. taxation on their investments in passive assets. Where the investor is subject to Subpart F, U.S. tax on passive income cannot be avoided.

Stated differently, Congress's concern was that under prior law taxpayers had an incentive to make investments in passive assets through foreign corporations. The opportunity for virtually perpetual deferral, however, was available only where an individual invested in foreign companies that were not CFCs. Thus, the target of the PFIC rules was passive income.

The House and Senate bills both specifically conformed the PFIC provisions to the Subpart F rules by providing the same treatment for U.S. shareholders in PFICs as for U.S. shareholders in CFCs. The Senate bill specifically provided (in proposed section 1246A) that the PFIC provisions would not apply when a corporation was already a CFC and the taxpayer was a U.S. shareholder of that CFC for purposes of Subpart F. As explained by the Senate Finance Committee (at page 397):

> [I]f a PFIC is otherwise a controlled foreign corporation and any U.S. investor is otherwise a U.S. shareholder, the bill's provisions do not apply and the U.S. investor is subject to the rules of Subpart F.

Clearly, the Senate Finance Committee intended the PFIC rules to operate as an alternative to the Subpart F rules in respect of passive income -- not as an additional tax on manufacturing income.

The Joint Committee's initial Summary of the Conference Committee Agreement, which was released August 16, 1986, supports the conclusion that the House-Senate conferees intended the Senate's interpretation of the provisions to prevail. With respect to the "conference agreement" on foreign investment companies, the Summary states:

> Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on identification of income and flow-through of income character and with technical modifications.

The Summary contains no evidence that the conferees intended to expand the scope of the PFIC rules to cover operating income. The final Summary of the Conference Agreement, dated August 29, 1986, also contained no reference to expanding the scope of the provisions. As in the formal committee reports, the emphasis of the August 29 Summary was that the PFIC rules would apply "to U.S. investors irrespective of the degree of aggregate U.S. ownership" -- i.e., to individuals rather than U.S. shareholders in a CFC.*

At this time, the proposed Technical Corrections Bill contains provisions that would resolve some of the problems with the PFIC rules. The potential tax on active business income of an operating subsidiary, however, is not addressed in the current version of the legislation. Thus, it remains a source of tremendous concern to TEI. We are convinced that this was not Congress's intent in enacting the PFIC rules, and we strongly urge the adoption of a technical correction to limit the scope of PFIC provisions to passive income.

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* That Congress did not intend for the PFIC provisions to reach CFC operating income is corroborated by the five-year revenue estimates for the PFIC provisions. The figures in the Senate Finance Committee Report and the Conference Report were essentially the same ($82 million and $81 million, respectively), despite the elimination of formal PFIC/Subpart F coordination. The Joint Committee's General Explanation also cites the $81-million estimate. If the conferees had intended to reach CFC operating income, the final revenue estimate would have reflected this change.

Furthermore, we do not believe Congress intended to abandon, almost cavalierly, one of the basic foreign taxation principles of the Code -- deferral -- by taxing U.S. shareholders of CFCs on operating income. The Subpart F rules, along with the foreign investment company rules and amendments to section 482 of the Code, were enacted by the Revenue Act of 1962. The enactment of these foreign tax provisions was accompanied by much fanfare and attention from U.S. companies operating overseas. A key issue in the vigorous debate over the scope of the rules was what type of income -- passive or active -- should be taxed. The original House bill would have taxed a U.S. shareholder on his share of a CFC's increase in earnings re-invested in "nonqualified property."*

Reaction to this provision in the House bill was decisively negative. Ultimately, the Treasury Department (which had originally proposed the wholesale elimination of deferral on all overseas income, including operating income) offered an amendment to tax only an "increase in earnings invested in certain U.S. property." (That provision replaced the provision taxing investments in nonqualified property.) Secretary of the Treasury Douglas Dillon explained that, under the amendment --

> "non-tax-haven profits, such as those of a manufacturing operation, would not be taxed [under the appropriate section] unless they were invested in certain U.S. property."

---

* "Nonqualified property" included any property that was acquired for purposes of expanding a CFC's overseas activities, even if those activities were performed by foreign operating companies that received no passive income. Qualified property, on the other hand, included foreign property that was "ordinary and necessary for the active conduct of a qualified trade or business."

Accordingly, the final bill contained no reference to "nonqualified property" or the taxation of operating income. (See I.R.C. Sec. 956.) Moreover, although Congress in 1976 re-examined the Code's method of taxing U.S. shareholders in CFCs, it has never manifested any intent to change tax policy concerning foreign operating income.

The foregoing discussion is intended both (i) to demonstrate the seriousness with which Congress has previously considered the issue whether foreign operating profits of CFCs should be taxed currently and (ii) to underscore that, whenever the subject has been considered, Congress has declined to tax profits or property of operating companies. We submit that, given this background, it is wholly implausible that Congress would have decided in the 1986 Act to abandon its longstanding policy of permitting deferral without allowing opportunity for comment or public hearings.

The evidence supports the conclusion that Congress did not intend such a change. This is particularly true since it is nowhere explicitly stated that the PFIC provisions were enacted for the purpose of currently taxing operating income. Because the ensuing result -- taxing operating income -- seems clearly inadvertent, we believe that it can and properly should be addressed by a technical correction.

To this end, TEI strongly recommends that the language of section 1246(A)(h)(4) of the Senate bill (exempting CFCs from the PFIC rules) be restored to the statute. Thus, the following exception should be enacted:

> EXCEPTION WHERE SECTION 951 APPLIES WITHOUT REGARD TO THIS SECTION. -- This section shall not apply to a taxpayer with respect to a corporation if, without regard to this section --
>
> (i) such corporation is a controlled foreign corporation (as defined in section 957), and

(ii) the taxpayer is a United States shareholder (as defined in section 951(h) with respect to such corporation.

We recognize that in testimony before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance on July 22, 1987, the Treasury Department itself voiced concerns about the overbreadth of the passive asset test.

Although the Treasury Department's approach could achieve the objective of avoiding PFIC taxation of operating income, TEI continues to believe that CFCs should be explicitly exempted from the PFIC rules and that any modification to the asset test should be applied to non-CFCs. A reasonable result could also be obtained, however, if assets producing income (i) that is subject to tax under Subpart F or (ii) that would have been subject to tax under Subpart F but for an exclusion in section 954(b) were not taken into account in determining PFIC status.

Finally, we suggest that a look-through rule be provided under which a foreign subsidiary deriving interest will not be considered to have derived passive income for purposes of the PFIC provisions --

(i) to the extent that a related corporation did not have passive income, or

(ii) if the interest was earned in the conduct of an active finance business of the foreign subsidiary.

Such a look-through rule is similar in concept to the rule discussed in the context of a foreign corporation and its subsidiary in the Joint Committee's General Explanation (at page 1026).

IV. Definitional Issues

The following comments concern issues pertaining to the definition of a PFIC under section 1296(a). Certain of the issues may be resolved in regulations, whereas others may require corrective legislation. In either case, guidance is essential at the earliest possible date so taxpayers can readily and with certainty determine whether they hold shares in a PFIC.

A passive foreign investment company is defined in section 1296 as any foreign corporation --

> (i) if 75 percent or more of its gross income for the taxable year consists of passive income, or
>
> (ii) if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of passive income.

The gross income test of section 1296(a)(1) is relatively straightforward.* Definitional issues relating to the asset test are more difficult. We first discuss problems common to both the income and asset tests and then turn to issues relating solely to the asset test.

1. Issues Common To Both Income and Asset Tests

a. Look-through Rules

Section 1296(b)(1) defines passive income as having the same meaning "given such term by section 904(d)(2)(A)." Section 904(d)(2)(A) states that --

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* Although the application of the gross income test would be relatively uncomplicated, we question whether it would produce the appropriate result. This is because the test would give greater weight to passive income than to sales income, since sales income is reduced by the costs of goods sold in determining gross income for tax purposes. To prevent this skewing, we recommend that section 1296(a)(1) be amended to provide that a foreign corporation engaged in the active conduct of a trade or business will not be a PFIC if 75 percent or more of its gross receipts (rather than its gross income) consists of passive income.

> "'passive income' means income . . . which would be foreign personal holding company income (as defined in section 954(c))."

Section 904(d)(3) provides a "look-through" with respect to dividends, interest, rents, and royalties received from a CFC whereby the limitation in which such income is included is determined according to the income of the CFC.

Section 1296(c) states that if a foreign corporation owns at least 25 percent of the stock value of another corporation, for purposes of determining whether such foreign corporation is a PFIC, --

> "such foreign corporation shall be treated as if it (1) held its proportionate share of the assets of such other corporation, and (2) received directly its proportionate share of the income of such other corporation."

The Description of The Technical Corrections Act of 1987 (which was prepared by the staff of the Joint Committee on Taxation) provides guidance with respect to the application of the section 904(d)(3) look-through rule in determining whether a foreign corporation is a PFIC. The Description states (at page 209):

> By incorporating the definition of passive income that is applied for foreign tax credit limitation purposes, the look-through rules contained therein (*i.e.*, secs. 904(d)(3) and (d)(5)), are, to the extent applicable, applied in determining whether income is passive for PFIC purposes as well.

We believe that the Description is correct. The Senate version of the 1986 Act contained a provision that made the section 904(d)(3) look-through applicable for determining PFIC passive income. Moreover, had the inclusion of section 904(d)(3) not been intended in the 1986 Act, passive income could have been defined in section 1296(b)(1) by direct reference to section 954(c) rather than to section 904(d)(2)(A).

Notwithstanding the foregoing, section 1296 is not as clear as it might be regarding this issue and thus should be clarified by technical corrections legislation. We note that the pending Technical Correction Bill would provide a section 904(d)(3) look-through rule for PFIC inclusions, but only for section 1293 purposes. We submit that the clarification should apply for purposes of both the income and asset test. Otherwise, a potentially anomalous situation would be created, as illustrated by the following example.

> Assume that a first-tier foreign corporation owns less than 25 percent of the value of stock in a second CFC. Assume further that the second foreign corporation has only active business income.
>
> When the first foreign corporation determines whether it is a PFIC, under the look-through rule, the income it receives from the second corporation is treated as business income. Absent a look-through approach for the assets, the assets (*i.e.*, the stock in the second corporation) would presumably be passive even though that asset generated active business income.

There is no reason for such inconsistent treatment. Accordingly, a technical correction should provide that the section 904(d)(3) look-through rule should apply for both the income and asset tests.

b. Section 954(c) Passive Income

Section 1296 bifurcates income into passive and business income. Assets are similarly divided between those producing passive and business income. Under section 1296(b)(1), the characterization of income or assets as passive is ultimately made under section 954(c). There is, however, a flaw in this approach. Section 954(c) excludes certain types of otherwise passive income earned from an active business, but not all types.

In an attempt to correct this, section 1296(b)(2) excludes certain types of banking and investment income.

Regrettably, this does not completely solve the problem. It is a basic concept of federal income tax law that certain assets that might otherwise be considered passive may have such a relationship to a business so as to be converted into business assets. (See Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).) This concept is recognized in the Conference Report on the 1986 Act, which states (at page II-644):

> It is expected that bona fide underwriters of securities will be excluded from classification as a PFIC . . . under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to Subpart F FPHC income by virtue of the dealer exception in sec. 954(c) . . . .

Since the securities in question would, even in the hands of dealers, generate dividends and interest that constitute "passive income" under section 1296(b), the classification of such securities held by dealers for sale to the public as other than passive assets is presumably based on the principle that passive income is to be disregarded when earned on assets used in a business.

An existing regulation recognizes this and provides guidance in a very similar situation. Under Treas. Reg. Sec. 1.864-4(c)(2), an asset is not treated as producing passive income if the asset is used in, or held for use in, the conduct of a trade or business. Ordinarily, an asset should be treated as used in, or held for use in, the conduct of a trade or business if the asset is --

> (a) held for the principal purpose of promoting the present conduct of the trade or business, as, for example, in the case of stock acquired and held to assure a constant source of supply for the trade or business; or
>
> (b) acquired and held in the ordinary course of the trade or business, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) otherwise held in a direct relationship to the trade or business.

For example, assume that a foreign corporation engaged in the manufacturing business is required to hold a large current cash balance for business purposes. The amount of cash balance so required varies because of the fluctuating seasonal nature of the foreign corporation's business. During a time when large cash balances are not required in daily operations, the company invests the surplus in interest bearing obligations. Since these obligations are held to meet the present needs of the business, they are held in direct relationship to that business. Consequently, the obligations would not be treated as passive assets. Moreover, the interest on these obligations would not be treated as passive income. (See Treas. Reg. Sec. 1.864-4(c)(2)(iv), ex. 1.)

Accordingly, in providing guidance with respect to whether income and assets are passive or active for PFIC purposes, we believe that the Treasury Department and IRS should consider the already developed standards under Treas. Reg. Sec. 1.864-4. If this were done, effort expended with respect to the needed regulations would be minimized. Moreover, taxpayers could be provided with certainty relatively quickly.

c. The Banking and Insurance Exception

The section 1296(b)(2) passive income exception for certain banks and insurance companies needs to be extended. That section permits the Secretary to extend this exception to other corporations, but the Joint Committee's General Explanation (at page 1025) suggests that the regulatory extension of this rule should be limited to foreign corporations engaged in the active conduct of a "banking" business.

TEI submits that this exception should also be extended to foreign corporations engaged (predominantly with unrelated parties) in the active conduct of a banking, insurance, financing, or similar business.

d. Income and Assets of a QEF Held By A Foreign Corporation *

When a foreign corporation elects to become a qualified electing fund, distributions from such corporation are excluded from the application of section 1291(a). (See I.R.C. Sec. 1291(d).) Nowhere, however, are the issues addressed from the standpoint of another foreign corporation of how to treat income, including distributions, received from, or assets of a QEF.

This issue becomes very important for a first-tier foreign corporation holding stock in a second-tier foreign corporation. Assume that the second-tier corporation elects to be a QEF. By making the election, the second-tier foreign corporation causes the U.S. shareholder of the first-tier foreign corporation to include in its income all income of the second-tier corporation. In essence, by making the QEF election, the second-tier corporation forgoes deferral, thereby "cleansing" itself of the PFIC taint. It would thus be inequitable to treat any income from or assets of the QEF as passive for purposes of determining the status of the first foreign corporation.

In the 1986 Act, the "netting concept" was introduced to avoid a similar problem in Subpart F. (See I.R.C. Sec. 954(b)(5).) Under the provision, passive income is not counted twice when paid between related parties. The adoption of a similar rule for PFIC purposes would operate, as follows: if a U.S. shareholder recognized passive income of a QEF, neither income from nor assets of the QEF would be

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* The following comments become relevant only if our prior recommendations concerning the coordination of Subpart F and the PFIC provisions are not adopted.

considered in determining the status of the foreign corporate shareholder of the QEF.

TEI recommends that this conclusion be codified by means of a technical correction.

2. The Asset Test

Most of the terms and concepts under the asset test will require clarification either by regulation or by technical correction. The language of section 1296(a)(2) is set forth below with each of the critical terms or concepts underscored:

> The average percentage of assets (by value) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

a. Average

The method of determining the average percentage for the year should be based on the average of values at the beginning and end of the foreign corporation's fiscal year. Use of this procedure would be consistent with the rule of Treas. Reg. Sec. 1.861-8(e)(2)(v) for the apportionment of interest expense.

b. Assets

On its face, the term "assets" for PFIC purposes includes all assets, but we believe this should be explicitly confirmed. Thus, the regulations should provide that the assets to be valued should include intangible as well as tangible assets.

TEI believes that if the asset test is to fairly measure the value of the foreign corporation's business investments against its passive investments, intangible assets such as patents, industrial know-how, trademarks, goodwill, and going concern value should be valued and included. Consequently, all intangibles should be included, regardless of how they were acquired or developed.

c. Value

The statute provides that the passive asset percentage shall be determined "by value." There is no indication in any of the relevant Committee Reports or the General Explanation that the term "value" means anything other than "fair market value." Nevertheless, we recommend that, as a matter of administrative convenience, a foreign corporation be accorded an option to establish that it is or is not a PFIC on the basis of "tax book values" (original cost for tax purposes less depreciation allowed for tax purposes).

This option parallels the choice allowed to taxpayers under Treas. Reg. Sec. 1.861-8(e)(2)(v). It would help reduce the extraordinary compliance effort that would be required if the PFIC status of all foreign corporations were contingent on the determination of fair market values. In this regard, consideration should also be given to an additional option which would permit the use of financial book values, based on reports prepared in accordance with U.S. generally accepted accounting (GAAP) principles.

d. Safe Haven

The potential for disputes over the fair market value of intangible assets will generate sustained uncertainty about the PFIC status of many corporations. We submit that the adoption of safe-haven rules would bring a desirable level of certainty into the process. Such rules would eliminate disputes concerning fair market values and would also alleviate the administrative identification problem for taxpayers that have not maintained detailed asset records.

An example of a fair and useful safe haven would be to value a foreign corporation's passive and non-passive investments based on its earnings and profits attributable to passive and non-passive income, respectively. The look-through rule in the case of 25 percent-owned corporations (section 1296(c)) could apply for this purpose. The safe-haven rule would simply provide that, at the option of the foreign corporation, the value of each category of underlying assets (passive and non-passive) would be deemed to be proportionate to the earnings and profits generated by that category for the taxable year.*

e. Produce Passive Income

This point is addressed above in connection with issues common to both the income and asset tests. TEI recommends the adoption of a section 864-type rule, under which (for example) interest collected on overdue receivables would not cause the receivables to be passive assets.

f. Held for the Production of Passive Income

As previously stated, some assets that are held to produce non-passive (i.e., active business) income have the potential for producing incidental passive income. We submit that the classification of such an asset should be based on the principal purpose for which the asset is held.

In this regard, we request that the regulations confirm that assets, such as land held for the expansion of operating facilities, are not held for the production of passive income.

V. Miscellaneous Issues

1. Perpetual PFIC Rule

Under section 1297(b)(1), stock is considered stock in a PFIC --

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* Although we believe the safe haven would be beneficial to many taxpayers, it might pose compliance burdens for others; consequently, it should be wholly elective, with taxpayers being permitted to value intangible assets using tax book values or financial book values, as discussed in the text.

> "if at any time during the holding period of the taxpayer with respect to such stock, such corporation (or a predecessor) was a [PFIC] which was not a qualified electing fund."

This rule, which has been characterized as the "once a PFIC, always a PFIC" rule, can produce extremely onerous results. Under section 1291(a), an excess distribution from a PFIC or sale of stock in a PFIC is subject to interest and potentially higher tax rates to the extent the distribution or gain is attributable to post-1986 PFIC years. A foreign corporation may meet the PFIC definition for 1987 and no other year, yet when the U.S. shareholder sells its stock in the foreign corporation, the shareholder will still be subject to an interest charge and potentially higher tax on the entire gain attributable under section 1291 to the post-1986 period.

Moreover, if a distribution is received from such a foreign corporation, all amounts attributable to post-1986 years will be subject to the interest charge even though the foreign corporation only met the PFIC definition for one year.

The above scenario is not unlikely in light of the surprisingly broad scope of the PFIC provisions and the confusion surrounding their enactment. Although operating companies that initially meet the PFIC definition may attempt to restructure or take other steps to avoid PFIC status in the future, the "once a PFIC, always a PFIC" rule will produce drastic consequences for these companies. All post-1986 earnings may be subject to an interest charge.

A measure of relief from this draconian result is offered by the "mark to market" election found in section 1297(b)(1). The "once a PFIC, always a PFIC" rule will not apply --

> "if the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a [PFIC]) under rules similar to the rules of section 1291(d)(2)."

By making this election, the operating company is not treated as a PFIC and will no longer be subject to the section 1291(a) interest charge.

Application of section 1291(d)(2), however, would require the taxpayer "to recognize gain as if he sold such stock." Thus, when an operating company is initially a PFIC but does not meet the definition in later years, it must pay a very heavy price to become a non-PFIC: the recognition of all gain, even that attributable to pre-1987 years. This is more severe than the result under section 1291(a) under which interest is only attributable to post-1986 years. This excessive toll charge will likely prevent most taxpayers from "cleaning" their PFIC slate.

TEI believes that the goals of the PFIC provisions would be better served by restricting gain recognition under the section 1297(b)(1) election to that portion of the gain attributable to the post-1986 holding period of the taxpayer as determined under section 1291. To ameliorate the potential administrative burden of the suggested rule, the increase in earnings and profits during the period of PFIC status could be utilized as the measure of the taxable gain.

This suggested approach would be more compatible with the approach taken in section 1248(a). Section 1248(a) of the Code converts what would ordinarily be capital gain to ordinary income upon sale of stock by a U.S. shareholder in a CFC. The conversion, however, applies only to gain attributable to years when the foreign corporation was a CFC.

2. Treatment of Interest

TEI asks that consideration be given to clarifying, by technical correction, the deductibility of interest under sections 1291 and 1294. Specifically, the PFIC provisions should be amended to make it clear that the interest component of the deferred tax amount under section 1291 and interest pursuant to a section 1294 election will be deductible. Such interest (reflecting the time value of money) should not, in effect, be a nondeductible penalty but should retain its interest characterization and, accordingly, be deductible.

3. Look-Through

Section 1293(f) provides that "for purposes of section 960," amounts included in income shall be treated as if included under section 951(a). The purpose of this treatment as a Subpart F inclusion is to allow foreign tax credits. Section 112(a)(11) of the pending Technical Corrections Bill would apply a section 904(d)(3) look-through for section 1293 PFIC inclusions. TEI recommends the adoption of such a technical correction. Absent the enactment of such a provision, section 1293 amounts would be included within the passive income basket.

4. Start-Up Companies

Under section 1297(b)(2), an exception to the PFIC rules is generally provided for the first taxable year that a start-up company has gross income.

TEI believes that such an exception is appropriate. We suggest, however, that the exception would be frustrated in situations where a start-up company only begins operations in, for example, December and elects the calendar year as its taxable year. In such a case, any relief provided by the exception would be nominal at best. To address this situation, we submit that a technical correction be adopted to provide, at a minimum, that a start-up company is not to be treated as a PFIC until its first taxable year that consists of more than six months.

VI. Conclusion

If you should have any questions about these comments, please do not hesitate to call Robert H. Perlman, chairman of TEI's International Tax Committee, at (408) 496-8113 or TEI Headquarters (Timothy J. McCormally or Richard N. Kappler) at (202) 638-5601.

TAX EXECUTIVES INSTITUTE, INC.

By: Thomas M. Nee
Thomas M. Nee
International President

TSG Holdings Inc.

July 20, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20510

Dear Mr. Leonard:

This letter is written to bring to your attention the need for a technical correction to the Tax Reform Act of 1986 with respect to the special rule, under the passive foreign investment company provisions, for corporations changing business. Such an amendment is necessary because companies in a state of transition from one or more active businesses to another active business or businesses when the 1986 Act was enacted will in many cases fail to meet one of the criteria for the special rule unless they were very close to completing the transition at that time.

The change-of-business rule is intended to permit a corporation that is actively engaged in a trade or business to reinvest the proceeds of selling that business without being treated as a passive foreign investment company during a reasonable interval between the sale of the old business and the resumption of active business activities through the new business. One of the criteria for qualifying for this special rule is that "substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of 1 or more active trades or businesses".

Transcontinental Services Group N.V. ("Transcontinental"), our parent company, was in transition when the 1986 Act was enacted, having disposed of its marine services businesses in 1984 and not having succeeded in investing the proceeds in appropriate new businesses, in spite of having considered carefully a number of business oportunities. While continuing to search for appropriate opportunities, Transcontinental invested the proceeds of the sale plus additional capital raised in the interim.

These interim investments (largely in U.S. stocks and securities) not only preserved capital, they increased the amount of capital for investment. In addition, the company took steps to protect its shareholders from exchange rate risk, since much of the capital was in pounds rather than dollars. As a result of the success of these interim investments and hedging strategies, we believe that Transcontinental may fail to meet the "substantially all" test.

We believe that our situation may not be unique, but that it is distinguishable from the passive investment vehicles at which the passive foreign investment company provisions were aimed. Unlike Transcontinental, the passive investment vehicles at which those provisions were aimed are not in transition between active trades or businesses and their passive income is not derived from proceeds from the disposition of such trades or businesses.

This problem is particularly acute for companies, such as Transcontinental, that were in such a transition at the time of enactment of the 1986 Act. The enclosed statement of Transcontinental's investment policy and management philosophy clearly demonstrates its commitment to re-entering the active trade or business market and reflects its efforts to do so since disposition of its marine services division.

Clearly, the Congress intended to provide a transition period for companies such as Transcontinental. The realization of that intent may be frustrated by the "substantially all" test, at least as it applies to companies in transition when the 1986 Act was enacted.

Therefore the amendment we seek to have included in the Technical Corrections Act would permit companies in transition to qualify for the special rule if substantially all the passive income for the taxable year is directly or indirectly related to the dispositon of 1 or more trades or businesses, viewing income derived from additional capital raised to fund the new investment as indirectly related to such a dispostion.

Sincerely,

L. O'Connell.

Laurence O'Connell

Enclosure

Transcontinental Services Group N.V.

John B. Gorsiraweg 6
Willemstad
Curacao
Netherlands Antilles

TRANSCONTINENTAL SERVICES GROUP N.V.

INVESTMENT POLICY AND MANAGEMENT PHILOSOPHY

Since selling its marine services operating division in 1984, the Company has concentrated its attention on businesses in the consumer services, financial services, retail and communications business sectors. To support these plans the Company has expanded its base of personnel having administrative, operating and services backgrounds. The Company, having established a significant capital base, through the sale of its former operating businesses and by raising additional capital, has spent its development period since 1984 focusing on the acquisition market process, particularly in the United States. It has spent this time prudently to learn this market, evaluate opportunity to acquire businesses in the service and retail sectors and subsequently made such investments when quality presented itself. Rather than move too quickly and risk its resources on mediocre investments, the Company prudently assesses each opportunity. High quality investments are not always readily available and access to them is highly dependent upon business's response to general economic conditions.

As a result of the foregoing, the Company is in a position to become increasingly active in the acquisition of operating companies with requisite qualities and future operating business prospects. It expects to move more rapidly towards its planned structure as an industrial holding company acquiring financial and management control of operating businesses.

The Company is confident that with the combination of its (1) sophisticated investment policy; (2) enhancement of management and staff; and (3) the economic climate which currently exists in the United States, it is positioned to pursue aggressively substantial investment in operating companies over the near future.

United States Council for
International Business

July 16, 1987

Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515
Dear Mr. Chairman:

PASSIVE FOREIGN INVESTMENT CORPORATION (PFIC) PROVISIONS (SECTION 1291-1297)

On behalf of the United States Council for International Business, I am pleased to respond to your request for comments on the pending Technical Corrections Bill (H.R. 2636).

The legislative intent in enacting the above provisions as part of the 1986 tax reform was to "eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds" (Conference Committee Report, P.L. 99-154, at II-641). The newly enacted provisions, however, are written in such broad terms that they will impact U.S. multinational corporations, in operating circumstances, which is well beyond the stated goal. (We believe that the intention to limit the target of this amendment to portfolio investors clearly emerges out of the revenue estimates.) The U.S. Council for International Business is greatly concerned with the potentially broad applicability of the new PFIC rules and its disruptive effect on bona fide business activities of U.S. multinationals competing abroad against the MNCs of other nations.

The United States Council for International Business represents American business in the major international economic institutions as well as before the executive and legislative branches of the U.S. Government. Its primary objective is to promote an open system of world trade, finance and investment. Through affiliations with the International Chamber of Commerce, the Business and Industry Advisory Committee to the Organization for Economic

Development (OECD), the Council officially participates in the work of the GATT, the OECD, the International Labor Organization, and the United Nations system.

The Council believes that the PFIC rules should give way to the controlled foreign Corporation (CFC) rules (Subpart F, Sections 951 through 964) in a much more substantial manner than that provided by the 1986 legislation and the pending Technical Corrections bill (see Section 951(f)).

More precisely, in the case of a U.S. shareholder, as defined in §951(b), of a CFC, the shareholder should not be subject to the PFIC provisions. (It may be noted that such was the rule under the Senate proposal which projected the same revenue effects as the statute actually enacted.)

In the brief period since enactment of the PFIC rules, it has already been noted that they can affect and possibly impede certain normal operating patterns which, under Subpart F, do not become currently taxable to the U.S. shareholders. For example, items of income, which are integral to certain business activities and which are subjected to high effective rates of foreign income tax (thus removed from "tax haven" income by Section 954(b)(4), would be classified as passive income for PFIC purposes. Such a treatment would necessitate current inclusion of the income by the shareholder(s), under the qualifying electing fund rules. Thus, this result is effectively an amendment to the Subpart F rules - indeed a virtual elimination of the long-standing Section 954(b)(4) exception in its application to passive types of income generated incidentally to an active overseas business.

We would strongly urge that the above exception to the PFIC provisions be enacted as soon as possible, with retroactive effect to January 1, 1987.

Yours very truly,

Richard M. Hammer

Richard M. Hammer
Chairman, Tax Committee

Section 1236

Banco Popular de Puerto Rico

HECTOR LEDESMA
VICE CHAIRMAN
BOARD OF DIRECTORS

July 15, 1987

Hon. Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Office Bldg.
Washington, D. C. 20515

Dear Mr. Chairman:

I am pleased to respond to your request for comments on the Technical Corrections Bill(H. R. 2636)by bringing to the attention of the Committee a matter that is of major significance to Puerto Rican banks.

As a consequence of successive amendments to the Internal Revenue Code a special provision, Section 882(e)originally enacted as a benefit to Puerto Rican banks, now operates adversely to their interest. The Puerto Rican banks are taxed on U. S. Government obligations while other non-U. S. banks are not taxed on such obligations. This anomaly results from the following legislative sequence:

1. Generally, banks organized in Puerto Rico are taxed as foreign banks under the Internal Revenue Code. As regulated members of the Federal Reserve system, Puerto Rican banks, as in the case of U. S. Mainland banks, meet reserve requirements by investments in U. S. government obligations. The banks incur interest expense on the funds they borrow to obtain the reserve assets. The problem relates to the interest received by the Puerto Rican banks on the U. S. government obligations held to meet the reserve requirements.

2. Prior to 1966, the interest received by Puerto Rican banks on government obligations (as in the case of such payments to other foreign banks) was subject to a 30 percent tax on the gross interest payment. This 30 percent tax made the investments uneconomic since the withholding tax was greater than the net income. Section 882(e)was enacted in 1966, so that U. S. tax would be imposed on a net basis for income from U. S. government obligations received by possession banks. This was achieved by deeming such income to be effectively connected with a U. S. trade or business and therefore taxable by the U. S. on a net income basis after deducting their interest expense. Thus, the 30 percent tax no longer applied.

3. In 1984, the Congress allowed U. S. Government obligations held by foreign persons to be exempt from the 30 percent or other U. S. tax. This exemption did not apply to Puerto Rican banks because section 882(e)was not changed; therefore, U. S. government obligations held by Puerto Rican banks continued to be taxable by the U. S.

4. The 1986 Tax Reform Act added a substantial additional tax-a branch profits tax-that applies to non-U. s. corporations that have effectively connected U. S. income. Since section 882(e)deems income from U. S. Government obligations to be effectively connected, Puerto Rican banks will pay not only the U. S. corporate tax on such income, but an additional branch tax liability. The total U. S. tax(corporate tax plus branch tax)is projected to generate losses on Puerto Rican banks' investments in U. S. government obligations.

The details of this sequence of events are set forth in an accompanying memorandum.

As a result, non-U. S. banks, other than Puerto Rican banks, can now hold qualifying U. S. Treasury securities free of any U. S corporate or withholding tax, while Puerto Rican banks, which hold such investments under banking requirements, are subject both to the U. S. corporate tax and the branch level tax on income from such investments. This result is based solely on the special rule(initially designed to be a benefit for Puerto Rican banks)that their interest income on U. S. obligations is deemed effectively connected income. In view of the evolution of the basic U. S. rules, what was once a benefit is now a serious penalty.

Puerto Rican banks, therefore, should not continue to be subject to the mandatory rule of section 882(e)deeming any interest received by them on U. S. government obligations to be effectively connected income since other non-U. S. banks are not subject to such taxation.

The deemed effectively connected income rule should be eliminated with rules to permit an orderly transition. This would have the effect of treating Puerto Rican banks in a similar manner as other non-U. S. banks.

This letter is written on behalf of a consortium comprised by Banco Popular de Puerto Rico, Banco de Ponce, Banco Central Corporation, and several other Puerto Rican banks.

Very truly yours,

HL/rfg
enclosure

Memorandum Re: Technical Corrections Required to Remedy Unintended Adverse Effects of the Tax Reform Act of 1986 on Puerto Rican Banks

Banks organized in Puerto Rico are being very adversely affected by apparently unintended results of the new branch level tax rules and other changes enacted as part of the Tax Reform Act of 1986. The combined effect of the 1986 and 1984 Reform Acts results in a discriminatory tax impact against Puerto Rican banks when compared to the tax treatment of other similarly situated foreign banks and foreign investors. The problem can be solved by a simple technical correction. This memorandum will describe the nature of the problem and the legislative remedy which is proposed.

BACKGROUND OF THE PROBLEM

For U.S. tax purposes, corporations organized in Puerto Rico are treated as foreign corporations. Foreign corporations which earn U.S. source investment income not effectively connected with the conduct of a trade or business in the U.S. are generally subject to a 30% flat-rate tax on the gross amount of this income. The tax, which is imposed by Section 881(a) of the Internal Revenue Code, is collected by requiring U.S. payers to withold it from payments to foreign corporations at the 30% rate or at a lower treaty rate, if applicable.

In the early 1960's, Puerto Rican banks pointed out to Congress that although they were treated as foreign corporations for tax purposes, they were also subject to U.S. banking regulations. Under those regulations, banks organized in Puerto Rico and other U.S. possessions are effectively required to hold large portfolios of U.S. government obligations to meet reserve requirements. Since the banks pay interest on the funds they borrow to acquire the U.S. government obligations, the 30% withholding tax on gross interest income from those obligations resulted in an unfairly high effective tax rate.

In response to this inequity, Congress included a relief provision in the Foreign Investors Tax Act of 1966. That provision, which was enacted as Section 882(e) of the Internal Revenue Code, provides that interest on U.S. government obligations received by banks organized in a U.S. possession shall be treated as income effectively connected with the conduct of a U.S. trade or business, regardless of whether it is in fact effectively connected. Accordingly, the interest which possession banks receive on U.S. government obligations is not subject to the 30% flat-rate tax on gross income, but instead is taxed at the regular corporate rates after allowance of deductions for expenses, including interest costs, regardless of whether or not the possession bank is engaged in a trade or business in the United States. The effect of this amendment was to permit Purto Rican banks their continued investment in U.S. government obligations without being exposed to the 30% gross income tax as the situation otherwise required for other foreign investors.

The 1966 amendment provided very necessary relief for possessions banks until 1984. By that year, Congress had grown concerned that the 30% withholding tax on investment interest paid to foreign investors had become a major impediment to the ability of U.S. coporations and the U.S. government to borrow abroad. To remove that obstacle, Congress included in the Tax Reform Act of 1984 a provision codified as Section 881(c) repealing the 30% withholding tax on interest paid on certain U.S. portfolio investments to foreign corporations and nonresident alien individuals. As a result, foreign banks not located in U.S. possessions and not engaged in a trade or business in the U.S. are now entirely exempt from U.S. income tax on interest earned on qualifying portfolio investments in U.S. corporate and government obligations. Foreign banks that are actually doing business in the United States may also invoke the portfolio interest exception if the income is not "effectively connected" with a U.S. trade or business.

Banks organized in U.S. possessions are also generally eligible to avail themselves of the exemption from tax on interest from U.S. portfolio investments. However, in amending the withholding tax provisions of Code Section 881(c), Congress apparently overlooked making a corresponding amendment to Code Section 882(e), which contains the special rule for interest paid on U.S. government obligations to possessions banks. As a result, the possession banks are still required to treat all income from U.S. government obligations as effectively connected with a U.S. trade or business and pay the tax on any net income resulting therefrom - even though the income may not in fact be connected with a U.S. trade or business. Thus, a provision (Section 882(e)) originally added to the Internal Revenue Code as a relief measure for possessions banks not only became unnecessary following the 1984 legislation, but actually placed them in a position of disadvantage in comparison with other foreign investors.

THE CURRENT PROBLEM

Certain changes made by the Tax Reform Act of 1986 will further aggravate the effect of continued applicability of Section 882(e). When the 1986 amendments are combined with the portfolio interest changes introduced in 1984 without a corresponding amendment to Section 882(e), the difference in tax treatment of Puerto Rican banks reaches a serious degree of discrimination when compared to other foreign banks. These problems are discussed in the paragraphs which follow.

. Branch level tax on interest

Section 884(f), enacted by the Tax Reform Act of 1986, requires foreign corporations to pay a 30% tax on the amount by which the interest expense claimed as a deduction in the federal income tax return exceeds the interest actually paid by the United States branch of the foreign corporation. Foreign banks filing federal income tax returns are required to compute the allowable interest deduction in accordance with a formula prescribed by Regulations Section 1.882-5. In general terms, the interest deduction determined in accordance with this regulatory provision depends on the amount of assets that generate "effectively connected income." By definition, U.S. government obligations owned by Puert Rican banks are "effectively connected assets" because of Section 882(e), and thereby attract to the federal return an interest expense deduction in excess of what is paid by the U.S. branch. The interest so determined is actually attributable to and is paid by the bank's non U.S. operations.

The effect of Section 884(f) is that it will require the possession banks to apply a branch level tax at the rate of 30% on the amount of interest expense paid by the bank which is allocated to the interest income from U.S. government obligations and claimed as a deduction against such income in the federal income tax return. In the usual case, this tax will far exceed the profit "spread" earned from the investments, and to a large extent will place the banks back in the same position they were in before Section 882(e) was enacted for relief in 1966. Other foreign banks are not so similarly treated.

. Branch profits tax

In addition to the branch level tax on excess interest deductions allocable to income from U.S. government obligations, Section 884 will generally impose a 30% tax on the net earnings of foreign corporations required to be reported in the federal tax return, to the extent such earnings are deemed not to be reinvested in the U.S. This is the equivalent of the 30% withholding tax which is generally imposed upon dividends paid from a U.S. subsidiary to a foreign stockholder.

The starting point in determining whether a foreign corporation will be subject to the branch profit tax is the concept of "effectively connected earnigns and profits" for the taxable year. In the case of Puerto Rican banks, this term includes, because of Section 882(e), the interest generated from U.S. government obligations. The effect of Section 884 is that Puerto Rican banks will be exposed to this additional tax on the net earnings attributable to their investments in U.S. government obligations, at such time as these earnings are considered under the rule as having been repatriated from the U.S. It should also be observed that Puerto Rican Banks not engaged in a U.S. branch operation are technically exposed to the branch profit tax because the interest earned on the U.S. obligations is considered as "effectively connected earnings and profits." Other foreign banks will be subject to the branch profit tax only to the extent of earnings generated and attributable to an actual branch operation being conducted in the United States.

. Dividend sourcing rule

Another change made by the Tax Reform Act of 1986 which may bring about unintended results due to the continuation of Section 882(e) is the amendment to Section 861(a)(2)(B), the sourcing rule for dividends from foreign corporations. The rule now provides that dividends received from a foreign corporation will be considered all or in part as U.S. source income if 25% or more of the corporation's gross income from all sources for the preceding 3-year period was effectively connected (or treated as effectively connected) with the conduct of a trade or business in the U.S. The Tax Reform Act of 1986 reduced the percentage threshold in this rule to the present 25% from 50%.

This rule is very significant for stockholders who are U.S. citizens residing in Puerto Rico, in that they are exempt under Section 933 from federal income tax on all income from Puerto Rican sources (instead, Puerto Rico residents are taxable on such income in Puerto Rico). The rule is also significant for other U.S. persons, for whom the result of the sourcing rule will determine whether they are entitled to relief from double taxation on the income through the foreign tax credit mechanism (dividends paid by Puerto Rican corporations to nonresidents of Puerto Rico are generally subject to Puerto Rican withholding taxes).

The continuing requirement of Section 882(e) that the Puerto Rican banks treat all income from U.S. government obligations as effectively connected income may bring some of these banks dangerously close to the new 25% threshold in the income sourcing rule. Dividends from foreign corporations which are not subject to Section 882(e) are not so jeopardized.

SUMMARY OF THE PROBLEM

In summary, as a result of apparently unforeseen consequences of the tax legislation in 1984 and 1986, Section 882(e) now has the following adverse effects:

1. Possession banks are exposed to federal taxes on the taxable income generated by investments in U.S. government obligations, which are not in fact connected with a U.S. trade or business, while other foreign investors making similar investments may enjoy complete exemption from federal income taxes.
2. It exposes the possession banks to the 30% branch level tax on interest expenses allocable to the income generated by these investments, a tax which will invariably far exceed the net income actually generated from the investments, while other foreign investors will be subject to these rules only in connection with income actually generated by the U.S. trade or business.
3. It exposes the Puerto Rican banks to the new 30% branch profits tax to the extent the net earnings from U.S. government obligations not related to the U.S. trade or business are deemed to have been repatriated from the U.S., while other foreign investors will be subject to these rules only in connection with income actually generated by the U.S. trade or business.
4. It exposes stockholders of the Puerto Rican banks to increased risk that all or part of their dividends from the banks will be treated, unjustifiably we believe, as U.S. source income possibly subject to double taxation.

The effects of the first three items can be seen in the accompanying illustration.

PROPOSED TECHNICAL CORRECTIONS

Unlike banks in Guam and certain other U.S. possessions, which are spared some of these federal tax problems by specific exceptions favoring those jurisdictions only (Sections 881(b) and 882(e)), the banks organized in Puerto Rico are alone in having to seek a legislative remedy.

It is evident that all of the above-cited problems are the result of the continued existence of the requirement under

Section 882(e) that the possession banks treat all income from U.S. government obligations as U.S. effectively connected income, even where such income is not in fact so connected. This rule was rendered unnecessary by the 1984 legislation repealing the 30% tax on U.S. portfolio debt investments by foreigners, and was rendered altogether inappropriate by the interaction of changes made by the 1986 legislation.

The most expeditious solution to all of these problems will be to include the following provision in the technical corrections bill currently being drafted:

- o Amend Section 882(e) to provide the possession banks with an election not to have this provision apply at all, effective for taxable years beginning after December 31, 1986.

This amendment would be the most straightforward remedy and would resolve all of the problems cited above. However, it should be anticipated that for some banks, the immediate shifts which may be necessary in their U.S. government investment portfolios to comply with the conditions of the portfolio debt investment rule will be imprudent from an investment standpoint (e.g., all U.S. government obligations issued prior to July 19, 1984 will have to be disposed of right away). These banks might prefer to continue to utilize Section 882(e) for its originally intended purpose (to avoid the regular 30% withholding tax) until the older investments can be disposed of without adverse effect, even if this might mean that they would continue to be exposed to the regular corporate income tax on the taxable income which might result. However, in foregoing the election out of Section 882(e), they should still be afforded relief from the harsh effects of the Tax Reform Act of 1986 cited herein. Accordingly, the following additional amendments are proposed.

- o For possession banks which may choose not to avail themselves of the "election out" of Section 882(e), amend Section 884, the branch tax rule, to provide that the taxes provided for in that Section shall be determined without regard to any income which is treated as U.S. effectively connected income solely by reason of Section 882(e), and the assets and liabilities related thereto.

- o Also for possession banks which may choose not to avail themselves of the "election out" of Section 882(e), amend Section 861(a)(2)(B), the dividend sourcing rule, to provide that the determination of U.S. effectively connected income for purposes thereof shall be made without regard to any income which is treated as U.S. effectively connected income solely by reason of Section 882(e).

ILLUSTRATION OF ADVERSE EFFECTS OF SECTION 882(e) ON PUERTO RICAN BANKS

	Puerto Rican banks	Other foreign investors
ASSUMED FACTS:		
Interest income from U.S. government obligations	$10,000,000	$10,000,000
Deductions allowed against effectively connected income:		
Interest expense allocated	(9,000,000)	N/A
Other expenses allocated	(500,000)	N/A
Taxable income	$ 500,000	N/A
TAX UNDER OLD LAW:		
"Regular" federal tax (34% of $500,000)	$ 170,000	None
ADDITIONAL TAXES UNDER NEW LAW:		
Branch level tax on interest deduction (30% of $9,000,000)	$ 2,700,000	None
Potential additional branch level tax on dividend equivalent amount (30% of $500,000 less $170,000)	$ 99,000	None

Section 1241 (includes IRC Section 7852)

July 10, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
United States House of Representatives
Washington, D.C. 20515
U.S.A.

Dear Mr. Chairman:

Re: H.R. 2636 : Alternative Minimum Tax Foreign
Tax Credit

On behalf of the members of the American Chamber of Commerce in France, I am writing to protest the inclusion of section 112(y)(2)(B) in the Technical Corrections Bill of 1987. This section would create double taxation for American citizens and businesses in France as well as in other countries with which the United States has concluded income tax treaties.

Specifically, section 112(y)(2)(B) would allow the 1986 Tax Reform Act's provision dealing with the 90% alternative minimum tax foreign tax credit limitation to supersede tax treaties. Congressional intent documented in committee reports and the Blue Book provides no indication that the inherent conflict with tax treaties was considered during the Congressional work on this provision of the 1986 Tax Reform Act. To retroactively override treaties in a Technical Corrections Act, with no public hearings, is inappropriate on matters so fundamental as those of the avoidance of international double taxation and the respect of intent of America's tax treaty network.

Undermining the principle of avoidance of double taxation in this manner would undoubtedly also undermine the expansion of American business abroad. It would also put the United States in a difficult position with respect to future negotiations on tax treaties. For these reasons we hereby request deletion of section 112(y)(2)(B) of the Technical Corrections Bill of 1987.

Very truly yours,

George P. Larounis
Vice President

THE AMERICAN CHAMBER OF COMMERCE IN FRANCE INC 21 AVENUE GEORGE V 75008 PARIS TEL. (1) 47.23.70.28 - (1) 47.23.80.26

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Honorary President
Maxwell M. Rabb
U.S. Ambassador to Italy
President
Michael N. Bitsas
Vice Presidents
Piero Chiummo
Daniel E. Gilioli
Sergio Minoretti
Guido Spagnolo
Treasurer
Achille Frattini

American Chamber of
Commerce in Italy

Via Cantù, 1 - 20123 Milano - Tel. (02) 86 90 661 - Telex 352128 - Cables AMERCAM - Cod. Fisc. / Partita IVA 01151000153

Milan, July 14, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Re: H.R. 2636 : Alternative Minimum Tax Foreign Tax Credit

On behalf of the members of the American Chamber of Commerce in Italy, I am writing to protest the inclusion of section 112(y)(2)(B) in the Technical Corrections Bill of 1987. This section would create double taxation for American citizens and businesses in Italy as well as in other countries with which the United States has concluded an income tax treaty against Double Taxation.

Specifically, section 112(y)(2)(B) would allow the 1986 Tax Reform Act's provision dealing with the alternative minimum tax foreign tax credit limitation to supersede tax treaties. Congressional intent documented in committee reports and the Blue Book provides no indication that the inherent conflict with tax treaties was considered during the Congressional work on this provision of the 1986 Tax Reform Act. To retroactively override treaties in a Technical Corrections Act, with no public hearings, is inappropriate on matters so fundamental as those of the avoidance of international double taxation and the respect of intent of America's tax treaty network.

Undermining the principle of avoidance of double taxation in this manner would undoubtedly also undermine the expansion of American business abroad. It would also put the United States in a difficult position with respect to future negotiations on tax treaties. For these reasons we hereby request deletion of section 112(y)(2)(B) of the Technical Corrections Bill of 1987.

Very truly yours,

M. Bitsas

Michael N. Bitsas
President

HHB/AO/dlr

AARO
THE ASSOCIATION OF AMERICANS RESIDENT OVERSEAS
49, rue Pierre Charron – 75008 Paris, France – Tél. : 42.56.10.22

July 9, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
United States House of Representatives
Washington, D.C. 20515
U.S.A.

Dear Mr. Chairman:

Re: Technical Corrections Bill of 1987: alternative minimum tax foreign tax credit (HR 2636 section 112 (y)(2)(B))

We are writing on a matter of the utmost importance to Americans overseas which, if not corrected, will result in clear and deliberate international double taxation.

The Tax Reform Act of 1986 provides for a 90% limit on the applicability of a foreign tax credit against the alternative minimum tax. We have previously reviewed the relevant Committee Reports and the General Explanation of the Tax Reform Act of 1986 ("Blue Book" dated May 4, 1987) for evidence of whether Congress intended Title VII of the Tax Reform Act of 1986 to override treaty obligations and found no such Congressional intent. Section 112(y)(2)(B) of the Technical Corrections Bill would establish retroactive Congressional intent in this respect, when in fact it appears that the subject of conflicts with tax treaties had not been raised.

If the U.S. tax treaty provisions designed to eliminate double taxation are deliberately overridden, double taxation will result in numerous cases: American citizens abroad are for the most part concentrated in countries with much higher taxes than in the United States. In addition to paying these high taxes, these taxpayers are nevertheless required to file U.S. income tax returns to report their worldwide income. Many of these U.S. citizens have had no U.S. income tax to pay through 1986 because their foreign taxes gave rise to a full foreign tax credit. In these cases, the alternative minimum tax calculation has also usually been reduced to zero for the same reason. **To the extent that the foreign tax credit on the alternative minimum tax would be limited to only 90% of the alternative minimum tax, there arises double taxation in direct conflict with the spirit of all of our international tax treaties.**

Since 1918 the Congress has provided for elimination of international double taxation through the foreign tax credit mechanism and the establishment of a vast tax treaty network to this end. We are amazed that a departure from such a longstanding and well-founded position would be taken in a Technical Corrections Bill and without public hearings on the subject. We respectfully bring this anomoly to your attention and request that you delete section 112(y)(2)(B) from the Bill as introduced in the House of Representatives on June 10, 1987.

AARO is a nonprofit, nonpartisan citizens' organization representing American citizens in 27 foreign countries. AARO regularly informs American citizens abroad on their tax responsibilities (and voting rights) and assists them in complying with the U.S. tax laws. However, we at AARO also feel it our duty to petition Congress when we discover an unfair situation developing with respect to Americans resident overseas.

Very truly yours,

ASSOCIATION OF AMERICANS RESIDENT OVERSEAS

Stephanie H. Simonard, President

SHS/RLA

FINANCIAL EXECUTIVES
INSTITUTE

1100 Seventeenth St., N.W.
Suite 1203
Washington, D.C. 20036
(202) 659-3700

July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Tax Committee of the Financial Executives Institute (FEI) wishes to express our grave concern with the approach towards tax treaties expressed in the Technical Corrections Act of 1987 which will have the effect of overriding treaty obligations in many situations. FEI is a professional business organization of 13,000 senior financial and administrative officers who are affiliated with some 6,000 companies in virtually all segments of the economy and who represent a broad cross section of American business.

One of the key factors for successful American foreign trade has been the wide approach for successful American foreign trade has been the wide network of double tax treaties the United States has negotiated with its trading partners. These lead to certainty of tax results and provide the stability that encourages international trade. furthermore, U.S. - based companies in the world marketplace would be at a significant disadvantage compared to their foreign competitors without such treaties.

Now this treaty network is being threatened by a proposed substantive change included in the Technical Corrections Act of 1987. An example of this bias can be found in Section 112 (y) of the proposed Act which provides, in effect, that all amendments made by the Tax Reform Act (with limited exceptions) override treaty obligations. This certainly is in conflict with longstanding policy not to override international agreements and contrary to the philosophy behind Section 7852 (d) of the 1954 Internal Revenue Code.

Taken to the extreme, these actions could lead to the collapse of the U.S. tax treaty network, economic double taxation and severe injury to American business engaged in international trade.

Such a course of action should not be taken and, in any event, such a substantive change as proposed by the Technical Corrections Act should be the subject of more extensive study as to the trade and economic implications and should be carefully considered with public hearings.

We would be pleased to have an opportunity to discuss this matter with you further.

Sincerely,

James R. Pratt
Chairman
Committee on Taxation

INSTITUTE OF FOREIGN BANKERS, INC.
200 PARK AVENUE, NEW YORK, NEW YORK 10166
(212) 682-2533

LAWRENCE R. UHLICK
EXECUTIVE DIRECTOR AND COUNSEL

July 15, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
The U.S. House of Representatives
Room 2111
Washington, D.C. 20510

Dear Chairman Rostenkowski:

I am writing to you as Executive Director of the Institute of Foreign Bankers, an association representing over 230 banking organizations from more than 50 countries with operations in the U.S., to express our deep concern over a provision in the proposed Technical Corrections Act of 1987. As explained more fully in the enclosed memorandum, section 112(y)(2) of the TCA would override U.S. tax treaty obligations generally and, in particular, would eliminate the protection foreign banks from certain treaty countries currently have against the so-called "excess interest" portion of the newly-enacted branch level tax.

There are simply no adequate tax policy or revenue reasons for such a treaty override, which would have significant and adverse effects on many of our member banks. Under these circumstances, it is clear that such a unilateral treaty override by the U.S. would upset the legitimate expectations of foreign banks and their home country governments with regard to these carefully negotiated treaties. Such action would cause concern on the part of U.S. treaty partners as to the reliability of U.S. treaty commitments. Moreover, unilateral override could well have adverse consequences for U.S. corporations with foreign operations, because these U.S. companies likewise derive considerable benefit from existing tax treaties.

In addition, overriding treaty commitments without a careful and considered examination of the likely effects of such action could cause other unintended adverse consequences. The unanticipated intensity of the negative reaction in the Eurobond markets to the recent notice of termination of the U.S. tax treaty with the Netherlands Antilles is a clear indication of the importance foreign investors place on U.S. treaty commitments.

For these reasons, the Institute urges that section 112(y)(2) be eliminated from the proposed Technical Corrections legislation. At a minimum, section 112(y)(2) should be amended and the accompanying legislative history should be drafted so it is clear treaties will not be overridden with respect to any protection afforded against the branch level tax, and, in particular, the excess interest component of this tax.

We appreciate your consideration of this important issue.

Sincerely yours,

Lawrence R. Uhlick

Lawrence R. Uhlick
Executive Director and Counsel

INSTITUTE OF FOREIGN BANKERS, INC.
200 PARK AVENUE, NEW YORK, NEW YORK 10166
(212) 682-2533

July 15, 1987

COMMENTS ON CERTAIN TREATY OVERRIDE PROVISIONS OF THE TECHNICAL CORRECTIONS ACT OF 1987

The proposed Technical Corrections Act of 1987 (the "TCA"), as introduced in the House and Senate on June 10, 1987, provides that with certain limited exceptions the amendments made by the Tax Reform Act of 1986 will apply notwithstanding any contrary U.S. treaty obligation.1/ For the reasons set forth below, the Institute of Foreign Bankers2/ urges that this broad override of U.S. treaty obligations be deleted. At a minimum, the provision should be amended so it is clear existing U.S. treaties will be available to protect treaty residents against the new branch level taxes, including specifically the branch level tax on "excess interest." In addition, the committee and conference reports accompanying the TCA should clearly express Congress' intent to that effect.

I. Background

The Tax Reform Act of 1986 made numerous changes to the rules governing the federal income tax treatment of foreign taxpayers. In particular, the Reform Act imposed two new branch level taxes on foreign corporations: a branch profits tax and a branch interest tax, which includes a so-called "excess interest" tax. Because banks organized in other countries frequently operate in the United States through branches for regulatory and business reasons, the branch tax primarily affects foreign banks. The excess interest tax is imposed on a foreign bank with a U.S. branch to the extent that interest deducted by the bank for federal income tax purposes under the formula method provided by Treas. Reg. § 1.882-5 exceeds the interest actually paid by its U.S. branch to its depositors or other creditors. Absent a treaty rate reduction or a statutory exemption, the tax is 30 percent of the excess interest amount.

The excess interest tax is imposed on the foreign bank itself, not on any recipient of interest paid by the foreign bank. As a result, foreign banks cannot pass on the cost of the excess interest tax to their creditors. Moreover, there is no such tax imposed on similarly situated U.S. banks or other U.S. corporations. Consequently, in the view of the Institute, the excess interest tax clearly violates the nondiscrimination clauses of most U.S. bilateral tax treaties. It also appears the tax would violate the provisions contained in a number of U.S. tax treaties that prohibit or sharply limit taxation by the United States of interest paid by a foreign corporation. These views of the excess interest tax are shared by many of the foreign treaty partners of the United States.

1/ H.R. 2636, S. 1350, 100th Cong., 1st Sess. § 112(y)(2) (1987).

2/ The Institute of Foreign Bankers is a trade association representing over 230 foreign banks from more than 50 countries with operations in the United States.

The staff of the Joint Committee on Taxation have taken the contrary position that the excess interest tax is not discriminatory.[3] This position overlooks the point noted above that the excess interest tax, unlike a withholding tax, is imposed on the payor (i.e., the foreign bank), not the recipient of the interest. In apparent recognition of the questionable validity of this position, the Joint Committee staff go on to state that "if, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty." This explicit intent to override treaties is carried out in section 112(y)(2) of the TCA, which provides that with certain narrow exceptions, the amendments made by the Tax Reform Act of 1986 shall apply "notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the Reform Act." Thus, it is clear that if the TCA is enacted in its current form, existing treaty nondiscrimination clauses will not be available to protect foreign banks from the excess interest tax.

II. The Proposed Treaty Override Should Be Deleted

1. The Proposed Rule Is A Major Change In Tax Policy

The treaty override rule proposed in the TCA constitutes a major departure from established U.S. tax policy that would significantly affect U.S. relations with its tax treaty partners. The proposed treaty override would be a unilateral abrogation of bilateral treaty commitments which could not fail to damage the standing of the United States with its trade partners. An action of such sweeping consequence should, at the very least, be considered only after hearings have been held and an effective opportunity for considered comment has been afforded to affected private parties and foreign governments.

2. Overriding Treaties Will Adversely Affect U.S. Corporations Abroad

Congress should be mindful that U.S. tax treaties are mutual compromises designed to benefit U.S. persons and businesses abroad, as well as foreign persons and businesses in the United States. The proposed treaty override would deny foreign persons the benefits negotiated for them by their governments, while retaining the significant benefits the United States has successfully negotiated for U.S. persons doing business overseas. Any action which so drastically undermines the protections negotiated by the treaty partners of the United States will offend these foreign governments and ultimately jeopardize the current favorable tax treatment of U.S. corporations abroad.

Moreover, the proposed treaty override rule comes at a time when the United States is attempting to renegotiate a number of its existing tax treaties. Demonstration by Congress of a willingness to override bilaterally agreed-upon treaty provisions in an unexpected manner will make prospective treaty partners lose confidence in their ability to reach an effective agreement with the United States, and thus severely undercut Treasury's ability to negotiate protection for U.S. individuals and corporations residing or doing business abroad.

In addition, overriding treaty obligations could well trigger other adverse consequences. The intense negative reaction in the Eurobond markets to the recent notice by Treasury of termination of the U.S. treaty with the Netherlands Antilles is a clear indication of the importance foreign investors attach to U.S. treaty commitments.

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[3] Staff of Jt. Comm. on Taxation, 100th Cong., 1st Sess., Description of the Technical Corrections Act of 1987 (Jt. Comm. Print June 15, 1987) at 235.

3. Treaty Overrides Are Not Needed To Combat Abuse Or To Further Other Tax Policy Objectives

Treaty overrides are conceivably defensible on tax policy grounds only in situations where there has been proven and sustained abuse of a treaty by foreign taxpayers with U.S. operations or investments, or where it is clear that failure to enact a treaty override will invite such abuse. For example, a recent treaty override provision contained in the Foreign Investors in Real Property Tax Act of 1980 ("FIRPTA") was reluctantly enacted by Congress primarily to prevent wholesale avoidance of the new tax through treaty abuse. At that time, a number of U.S. treaties would have prevented the tax, but no adequate protection existed in U.S. tax law or in the treaties themselves against treaty-shopping. In order to prevent foreign investors from simply routing their U.S. real estate investments through a country with a favorable treaty, Congress provided that the new tax enacted by FIRPTA would override any contrary treaty provision beginning five years after the enactment of FIRPTA.

In contrast, no treaty abuse or risk of treaty abuse exists in the present context. First, foreign banks, the foreign corporations most widely affected by the branch level tax, are not among the categories of foreign investors that have historically abused income tax treaties. The overwhelming majority of foreign banks with U.S. operations are large publicly-traded institutions in their home countries. These banks have not made improper use of other countries' treaties and the Institute is not aware of any contrary allegation. Second, the Tax Reform Act of 1986 largely eliminated the opportunities for treaty-shopping by foreign taxpayers, primarily through the enactment of "qualified resident" limitations on treaty benefits. These rules are more than adequate to protect against any treaty abuse.4/

4. The Proposed Treaty Override Will Not Produce Significant Revenue

Finally, it must be emphasized that permitting the excess interest tax to override U.S. treaty obligations would not result in a significant revenue gain for the Treasury. Rather, the excess interest tax would be so burdensome that foreign banks simply could not pay the tax and maintain a competitive position as compared with U.S. banks and other foreign banks not subject to the tax.

Foreign banks in the United States already pay a "foreign premium" for their domestic funds depending in large part on the domestic perception of the quality of the bank. Accordingly, the excess interest tax will force foreign banks either to cease or sharply curtail U.S. operations in branch form or, as explained below, to restructure the funding of their U.S. branches in an artificial manner solely to avoid risking imposition of the tax.

5. The Proposed Treaty Override Will Place Foreign Banks At A Competitive Disadvantage

Foreign banks may be forced to seek to reduce or eliminate their exposure to the excess interest tax by funding U.S. branches to the extent possible through increased borrowings in the U.S. financial markets. However, for the reasons noted below, this course of action will serve only (i) to disrupt the normal financing practices of many foreign banks in their home

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4/ Importantly, these rules have been criticized by several European treaty partners of the United States. We understand that six European nations have submitted or will submit to Treasury a demarche setting forth their position on this issue. This concerted action by the European governments is further evidence of the sensitivity of foreign governments to unilateral U.S. legislative overrides of treaties.

country markets; (ii) to reduce the level of head office funds allocated to U.S. offices and thus to reduce the quasi-capital funds available on the books of those U.S. offices and (iii) to place these foreign banks at an increased competitive disadvantage with regard to the funding of their U.S. operations.

In general, banks have greatest access to the deposit markets in their home countries, and thus can achieve, on average, the lowest cost of funds by borrowing there. For example, U.S. banks typically obtain most of their low-cost funding in the United States because of their large retail deposit base in this country. The same is true for most foreign banks in their respective home countries.[5] However, the excess interest tax will deny foreign banks the use of such low-cost funds for their U.S. branches because the transfer of any such funds to the U.S. branch by the home office would create potential exposure to the excess interest tax. Thus, foreign banks potentially subject to the excess interest tax will be forced to place greater reliance on higher-cost funds in the United States than their domestic competitors and their foreign competitors not subject to the tax.

III. Conclusion

The Institute can see no sound rationale for a tax proposal that will (i) unilaterally abrogate existing U.S. treaty obligations when there has been no demonstrated or asserted treaty abuse; (ii) create a significant risk of adverse reaction by U.S. treaty partners with regard to U.S. corporations operating abroad; (iii) raise no significant amount of new revenue; (iv) disrupt the normal funding operations of many foreign banks; and (v) put foreign banks at an increased competitive disadvantage with regard to their funding operations in the United States.

The principal effects of section 112(y)(2) will be reduced competition in the U.S. banking markets, which can only work to the disadvantage of U.S. corporate borrowers and their shareholders, and reduced foreign investment in the United States with no significant increase in tax revenue. Consequently, the Institute urges that section 112(y)(2) of the TCA be deleted or, at a minimum, amended in the manner noted above.

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[5] To the extent these lower-cost funds are currently used by the U.S. office of a foreign bank, the lower cost of such funds is reflected in the foreign bank's calculation of its interest expense deduction under Treas. Reg. § 1.882-5. Thus, foreign banks gain no tax advantage by using such low-cost funds in their U.S. operations.

NATIONAL FOREIGN TRADE COUNCIL, INC.

100 EAST 42ND STREET, NEW YORK, N.Y. 10017 (212) 867-5630

July 16, 1987

Robert J. Leonard, Esquire
Chief Counsel, Committee on Ways and Means
U. S. House of Representatives
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RE: HR 2636
Technical Corrections Act
Section 112(y)/Sec. 7852 IRC

Dear Mr. Leonard:

In response to the request for comments in Press Release #12 on HR 2636, I respectfully submit the following on behalf of the Tax Committee of the National Foreign Trade Council, Inc., an organization of more than 500 U. S. firms engaged in all aspects of international trade and investment.

The Council is concerned that the bilateral tax treaties to which the U. S. is a party have been severely affected as a result of the Tax Reform Act of 1986. The proposal Technical Corrections Act would go even further in eroding these essential tools of international business.

- American business has a great stake in U. S. tax treaties which significantly reduce the foreign tax costs of operating abroad. This is particularly so in the new era of lower U. S. tax rates and, consequently, diminished foreign tax credits. Preserving the foreign tax savings achieved by U. S. tax treaties is imperative in order to promote U. S. international competitiveness.

- If the U. S. expects other countries to abide by the bargain made in U. S. tax treaties, the U. S. must live up to its treaty commitments. Overriding treaties by statute not only violates internatinal law, but represents bad business dealing with our treaty partners and invites retaliation. If elements of the deal that has been struck are to be changed -- for example, to accommodate new U. S. tax policies -- this should be done not by unilateral fiat, but through the negotiation process. While country-by-country negotiation is admittedly a time-consuming process -- and so might entail some delay in implementing the new tax policies -- in the long run the U. S. benefits from the resulting stability of its treaty network.

- In the rare instances where treaty provisions must be overridden by a statute coming later in time, constitutional restraint governs that this should be done only after full and careful consideration of the reasons and then as narrowly and as specifically as possible. The Technical Corrections Bill wrongly casts aside such restraint by including a "catch-all" override, so that in the case of any now-unknown conflict between the 1986 Act and existing U. S. treaty obligations, the 1986 Act would prevail. We urge deletion of this provision of the Bill (Section 112(y)(2)(C).

We appreciate the opportunity to submit these comments.

Yours very truly

Thomas J DuBos

Thomas J. DuBos
Chairman
Tax Committee

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July 16, 1987

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Re: Branch Profits Tax

Dear ~~Mr. Leonard~~ Bob:

The following comments are submitted for consideration with respect to H.R. 2636, the Technical Corrections Bill of 1987 (the "Bill"). These comments suggest a correction to the branch profits tax provisions of section 884 of the Internal Revenue Code of 1986 (the "Code") which were added by section 1241 of the Tax Reform Act of 1986 (the "Act").

I am writing with regard to the impact of the branch profits tax on U.S. stockholders of U.S.-owned foreign corporations. As regards such stockholders, the actual effect of the branch profits tax is contrary to the policy underlying its enactment and is at odds with the legislative history accompanying the Act. Accordingly, the Technical Corrections Act should amend section 884 of the Code so that U.S. stockholders of U.S.-owned foreign corporations will not bear the additional burden of the branch profits tax.

Background

Prior to the Act, a U.S. branch of a U.S.-owned foreign corporation whose income was effectively connected with the conduct of a U.S. trade or business paid U.S. tax at normal corporate rates on that income; when dividends were paid to its U.S. stockholders, section 245 of the Code provided a 100 percent dividends received deduction. If, instead, the U.S. branch had been organized as a U.S. subsidiary under prior law, the result would have been the same. As a U.S. corporation, the U.S. subsidiary would have been taxed on its income at normal corporate rates, and its U.S. stockholders would have been entitled to a 100 percent dividends received deduction under section 243 of the Code. No second level withholding tax applied to such dividends paid by a U.S. branch or a U.S. subsidiary because the recipients of those dividends were U.S. persons.

The 1986 Act Provision

Under the Act, the second level withholding tax generally has been displaced by the new branch profits tax of section 884 of the Code. Congress believed that the branch profits tax would be easier to administer and collect than the second level withholding tax. As discussed below, the Congressional policy underlying the branch profits tax was that it would eliminate an unintended advantage afforded to a U.S. branch of a foreign corporation which, unlike a U.S. subsidiary of a foreign corporation, could easily avoid the second level withholding tax on dividends and interest paid to its foreign shareholders. An unintended result of the branch profits tax, however, is that a U.S.-owned foreign corporation is subject to the branch profits tax, even in cases where the second level withholding tax is inapplicable, in addition to being taxed at U.S. corporate rates on its effectively connected income.

The following example illustrates how substantial the added burden of the branch profits tax is on U.S.-owned foreign corporations. Under current law, a U.S.-owned foreign corporation that earns $1,000 of income which is effectively connected with the direct conduct by it of a U.S. trade or business will pay $340 of U.S. corporate tax (34 percent), and will also pay a branch profits tax of $198 (30 percent) on the resulting $660 of earnings and profits. As a result, $462 is available to distribute to the foreign corporation's U.S. stockholders. On the other hand, if the corporation were a U.S.-owned U.S. corporation or conducted its U.S. business through a U.S. subsidiary, $660 ($198 or 43 percent more) would be available for distribution to the corporation's U.S. stockholders.

The legislative history provides no indication that Congress intended the branch profits tax to subject U.S. stockholders of such U.S.-owned foreign corporations to the disparate tax consequences illustrated by the example above. See H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985) (the "House Report"); S. Rep. No. 313, 99th Cong., 2d Sess. (1986) (the "Senate Report"); H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) (the "Conference Report"). Rather, Congress intended in adopting the branch profits tax that U.S. branches of foreign corporations engaged in a U.S. trade or business "should be subject to the same substantive tax rules" as U.S. subsidiaries of foreign corporations. House Report at 432.

A Desire for Symmetry

The underlying concern which gave rise to the congressional policy to provide symmetry for U.S. branches and U.S. subsidiaries was that an unintended incentive existed for foreign corporations to utilize U.S. branches instead of U.S. subsidiaries to conduct business in the United States. This incentive existed because while dividends and interest paid by a U.S. subsidiary to its foreign shareholders were always subject to the second level withholding tax, "no comparable shareholder-level taxes were imposed by the United States on the distributed profits or remitted interest of a U.S. branch of a foreign corporation (except in the limited case of a U.S. branch of a foreign corporation engaged in the commercial banking business)." Staff of Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 1036 (Comm. Print 1987) (the "Blue Book"). Although foreign corporations were subject to this second level withholding tax if 50 percent of more of their gross income was effectively connected with the conduct of a U.S. trade or business, Congress recognized that "nearly all foreign corporations with branches in the United States avoided liability for the withholding taxes . . . because their income was kept beneath the 50-percent threshold." Blue Book at 1036-1037. Thus, Congress' concern was that U.S. branches of foreign corporations were only effectively subject to one level of U.S. taxation while U.S. subsidiaries of such corporations were subject to corporate and shareholder levels of taxation.

Despite this evident focus, the Blue Book states that "[i]n Congress' view the [branch profits] tax will reduce the disparity in the tax treatment of foreign corporations doing business in the United States through a U.S. branch and a U.S. subsidiary, even where the foreign corporation is owned by U.S. persons." Blue Book at 1037 (emphasis supplied). The Blue Book illustrates the point with an example that compares the taxation of a U.S. branch and a U.S. subsidiary, each of which is wholly-owned by a foreign corporation that in turn is wholly-owned by a U.S. corporation. Under prior law, the earnings of such a U.S. subsidiary were subject to three levels of taxation (U.S. corporate tax on the earnings of the U.S. subsidiary, U.S. withholding tax on dividends paid to the foreign corporation and U.S. corporate tax on the dividends received by the U.S. parent from the foreign corporation), while the U.S. branch was subject to only two levels of taxation (U.S. corporate tax on the earnings of the U.S. branch and U.S. corporate tax on the dividends received by the U.S. parent from the foreign corporation). The Blue Book implies that the branch profits tax establishes parity in this situation by insuring an intermediate level of tax on the "profits remitted from the U.S. branch to the foreign corporation." Id. Any such "disparity" existing under prior law, however, was not caused by the ineffectiveness of the second level withholding tax as applied to a U.S. branch of a foreign corporation--the perceived defect in pre-Act law which the branch profits tax was expressly intended to address--because the second level withholding tax was and is inapplicable to "profits remitted from the U.S. branch to the foreign corporation." Rather, the three level tax burden on the U.S. subsidiary described in the Blue Book is the result of an unrelated problem, namely, the fact that a U.S. stockholder may not claim a foreign tax credit for any U.S. withholding tax imposed on dividends received from a foreign corporation.

The imposition of the branch profits tax on U.S.-owned foreign corporations cannot be justified by the fact that the type of U.S. subsidiary described in the Blue Book is also subject to three levels of taxation. The appropriate comparison that should be made is that of a U.S.-owned foreign company doing business in the United States with a U.S.-owned U.S. company doing business in the United States (not with a U.S.-owned foreign holding company as in the Blue Book). Prior to the Act, such U.S.-owned corporations paid U.S. tax on their earnings, and their U.S. stockholders were taxed (subject to the availability of the dividends received deduction) on any dividends they received. Thus, under prior law no disparity existed which Congress could have intended to cure through the branch profits tax. To the contrary, as illustrated in the example above, the branch profits provisions of the Act create disparity by not providing U.S. stockholders of U.S.-owned foreign corporations with relief from the additional burden of the branch profits tax which U.S. stockholders of U.S. corporations do not bear.

The Solution

The most appropriate way to resolve this problem would be to provide a tax credit to U.S. stockholders of U.S.-owned foreign corporations for the branch profits tax. Consistent with Congressional intent, the incidence of the branch profits tax would thereby be limited to foreign shareholders, including those who might otherwise have been successful in avoiding the second level withholding tax. Such a credit for the branch profits tax could be modeled after the provision which was contained in the House Ways and Means Committee's version of the Act. H.R. 3838, 99th Cong., 1st Sess. § 651 (1985) (proposed § 883(f) of the Code); see House Report at 434-35.

The fact that the Act did not provide U.S. stockholders with a branch profits tax credit does not reflect a Congressional decision that the result intended to be produced by such a credit was inappropriate. Rather, the legislative history makes clear that the Managers had the impression that the inclusion of such a credit under section 884 of the Code would be surplusage. The Conference Report, which generally adopted the Senate's amended version of the branch profits tax, stated that "[t]he Senate amendment does not adopt the branch tax credit, but achieves a similar result in expanding the availability of the dividends received deduction." Conference Report at II-647. Contrary to the statement in the Conference Report, however, the dividends received deduction only provides a "credit" for U.S. stockholders in that it eliminates the burden of double corporate level taxation. It clearly does not and indeed cannot eliminate the effect of the intermediate level branch profits tax on U.S. stockholders.

Conclusion

Congress focused upon the fact that there are corporate and shareholder levels of tax for foreign corporations owned by U.S. persons, and for U.S. corporations owned either by U.S. persons or by foreign persons. It enacted the branch profits tax to ensure that U.S. branches of foreign corporations would be effectively subject to two levels of taxation, something not assured under pre-Act law. Congress did not intend to create the disparity in the tax treatment of U.S.-owned U.S. corporations and U.S.-owned foreign corporations that results because of the enactment of the branch profits tax. Therefore, via the Bill the Act should be amended to accomplish the result the Managers indicated they felt had been accomplished. This can be done by providing a branch tax credit for U.S. stockholders of U.S.-owned foreign corporations.

If you have any questions about these comments, please call me at (202) 862-1073.

Sincerely yours,

Larry

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July 15, 1987

Congressman John Duncan
House Ways and Means Committee
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Washington, D.C. 20515

Dear Congressman Duncan:

We respectfully submit our comments on an amendment to the Tax Reform Act of 1986 (Act) proposed by the Technical Corrections Bill of 1987 (Bill) regarding the application of U.S. treaties to the branch level interest tax. Specifically, Bill Section 112(y)(2) provides that amendments made by the Act, with certain enumerated exceptions, will apply notwithstanding any U.S. treaty obligations in effect on the date of enactment of the Act. The Joint Committee Staff's description of the Bill states that the branch level interest tax is among the Act provisions intended to be read consistently with U.S. treaties. Consequently, if the branch level interest tax is in conflict with U.S. treaty obligations, the Act provisions will override the treaties. We are in disagreement with this view.

At the heart of the conflict between the branch level interest tax and many U.S. treaty obligations is the issue of whether the tax is discriminatory. The Act Conference Report indicates a general intention for treaty nondiscrimination provisions similar to Article 24(3) of the U.S. 1981 Model Income Tax Treaty to override the application of the branch profits tax, although there is no mention of the branch level interest tax. The Joint Committee Staff's description of the Bill concludes that the mere collection of the branch level interest tax from the foreign corporate payor of interest, rather than requiring the payor to withhold U.S. tax on interest payments throughout its taxable year, does not make the tax discriminatory. This rationale appears to be based on the notion that there is no economic difference as to whether the borrower or the lender incurs the tax because the parties will adjust the gross interest rate so as to provide the same after-tax rate to the lender. The tax purports to put U.S. permanent establishments of foreign corporations on an equal footing with U.S. corporations with respect to the cost of interest payments to foreign lenders. Although this intended result may occur in some isolated cases, we believe that in the majority of cases the tax will result in a greater tax and economic burden on foreign corporations as compared to U.S. corporations in the same circumstances. Particularly in the case of foreign banks, the tax is likely to result in economic double taxation, the burden of which will be borne by the banks' U.S. permanent establishments.

Our belief that the branch level interest tax is discriminatory can be demonstrated on a technical, economic, and administrative level. The salient points of our argument can be summarized as follows:

- The branch level interest tax is an additional tax imposed on a U.S. permanent establishment of a foreign corporate borrower that is not imposed on a U.S. corporation. Consequently, as a technical matter it discriminates against foreign corporations. It is not significantly distinguishable in its operation from the branch profits tax, which is considered by Congress and the Treasury Department to be discriminatory.

- As is the case under U.S. tax principles, it is likely that most, if not all, foreign taxing systems would deny a foreign tax credit for the branch level interest tax to either the borrower or the lender. Consequently, the likelihood is that the borrower would bear the burden of economic double taxation.

- In instances where a foreign corporation has a wide range of liabilities, such as banks, it is administratively impossible, to relate the branch level tax to a particular loan.

Branch Level Interest Tax is Technically Discriminatory

On a technical level, we believe a close examination of the terms of Article 24(3) of the U.S. Model Treaty indicate that the branch level interest tax is discriminatory irrespective of its economic effect. The crux of this conclusion is that the branch level interest tax is an additional tax imposed on a U.S. permanent establishment of a foreign corporate borrower that is not imposed on a U.S. corporation. This is based on the U.S. Model Treaty language which states that taxation on a U.S. permanent establishment "shall not be less favorably levied" than taxation on U.S. enterprises. The OECD Commentary on the identical provision of the OECD Model Income Tax Treaty indicates that, although the U.S. may tax foreign corporations differently than U.S. corporations for practical purposes, the taxation may not be more burdensome. We believe that the branch level interest tax is an additional tax that does not apply to U.S. corporations. It is not merely a different levy as it does not replace a levy on a U.S. corporation. Instead, it moves the actual incidence of taxation from the borrower to the lender.

Furthermore, we fail to see how the branch level interest tax is distinguishable from the branch profits tax in its discriminatory nature. The conclusion that the branch profits tax is discriminatory by the Joint Committee appears to be based on the technical argument above that the tax does not replace a comparable tax imposed on U.S. corporations, and that the incidence of taxation is moved from the shareholder of a foreign corporation to the foreign corporation itself. Certainly, by comparison, the branch level interest tax should be viewed as discriminatory in that it shifts the U.S. tax burden from an unrelated lender to the foreign corporation.

Branch Level Interest Tax Results in Economic Double Taxation

As stated above, it appears that the rationale for the conclusion reached in the Joint Committee Staff's description of the Bill, which ignores the technical arguments noted immediately above, was based on the belief that there is no economic difference as to whether the borrower or lender incurs the tax. If this in fact is the underlying rationale, we believe the following should be considered.

The branch level interest tax is imposed on foreign corporate payors of interest. Under U.S. tax concepts a foreign tax credit for such a tax would be denied to either the borrower or the lender. With respect to the former the tax would not meet the criteria of an "income tax", while with respect to the latter it would not be treated as imposed on the income recipient. It would therefore be unreasonable for us to expect that our treaty partners would allow a foreign tax credit for this tax. Consequently, the likelihood is that this tax would be borne by the foreign corporate borrower and would be viewed as an added cost of doing business in the United States. Economic double taxation would result.

In the case of a financial institution that derives its profits by relending funds at a marginal spread, a 30 percent tax on the gross interest payment would result in most, if not all, of its transactions subject to such a tax, generating losses. The bank would not be in a position to pass this cost on through reducing the rates paid to lenders nor increasing rates charged to its borrowers since rates are generally set by a very competitive market place. Nor would the market adjust to a rate change because of this tax. Non-U.S. banks operating on an international scale which have U.S. branches and raise funds for that branch outside of the United States compete with both non-U.S. banks which have no U.S. branches and with U.S. banks. Both of these competitors can raise funds in the local foreign market without subjecting interest paid to a U.S. withholding tax. In the case of a U.S. bank these funds can then be imported into the U.S. to fund their U.S. branches without being subject to U.S. withholding tax or comparable branch level interest tax. Furthermore, it would be safe to state that U.S. financial institutions would never borrow funds at market rates where the interest payment was subject to U.S. withholding tax subject to a "net loan" provision. In effect, this tax suggests that foreign banks should do so. It is somewhat ironic that the purpose for this tax was to place U.S. branches of foreign corporations on par with U.S. subsidiaries of foreign corporations. It seems to us that U.S. financial institutions will now have significant advantages over U.S. branches of foreign financial institutions.

Even in the unlikely event that the country of residence of the borrower does allow a foreign tax credit for the U.S. branch level interest tax, a problem still exists in that the credit has been moved from the lender's country of residence to the borrower's. This would result in many U.S. treaty partners having to bear an unintended burden for relieving double taxation.

Branch Level Interest Tax is Administratively Discriminatory

Even, in the unlikely event that the country of residence of the lender would allow a foreign tax credit for the U.S. branch level interest tax, the administrative burden in the case of a financial institution would be substantial. Since the tax is imposed on the excess interest deduction of the U.S. permanent establishment, which in theory is an allocation of a pro rata portion of a composite of the world-wide third party interest paid by the taxpayer, it would create an administrative nightmare to attempt to relate the added tax cost to any particular lender.

In summary, we believe the branch level interest tax may apply in a nondiscriminatory manner in only a few cases, but will be discriminatory in the case of foreign banks. Banks will almost certainly be forced to absorb the tax. Consequently, the Technical Corrections Bill should be revised to include guidance that treaty nondiscrimination provisions will override both the branch profits tax and branch level interest tax.

We thank you for this opportunity to provide you with our comments on this matter.

Very truly yours,

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U.S. House of Representatives
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Washington, D.C. 20515

Dear Sir:

I am writing to register opposition to the approach toward tax treaties in the Technical Corrections Act of 1987, both in general and in specific regard to the tax on "excess interest" imposed under the new "branch level" tax regime enacted by the Tax Reform Act of 1986. That approach deviates from traditional U.S. policy in international tax matters and is likely to result in harm to U.S. business and other interests abroad.

Section 112(y) of the Act, entitled "Coordination with Treaties," contains in subparagraph (2)(C) a sweeping clause to the effect that any and all amendments made by the Tax Reform Act shall apply notwithstanding any treaty obligation of the United States, except as otherwise provided in the Reform Act or in paragraph (3) of that same section. Paragraph (3) lists eight specific provisions of the Reform Act which are not to apply to the extent their application would be contrary to U.S. treaty obligations.

A Joint Committee Print which describes the Technical Corrections Act briefly reviews the statutory scheme described above and then sets forth the understanding of the authors of the Print that there are no other "cases . . . where a harmonious reading of the Act and U.S. treaties is not possible." On page 235 of the Print, the following statement appears:

> Other Act provisions that are understood to be fully consistent with U.S. treaty obligations include the Act's dual residence company provisions (Act sec. 1249) and the Act's branch level interest tax provisions (Act sec. 1241). In the latter case, the obligation for U.S. tax on a foreign corporation's "excess interest" arises from the foreign corporation's deduction of interest on amounts payable to third-party lenders. The mere collection of this tax at one time (i.e., the end of the corporation's taxable year) from the foreign corporate payor of interest, rather than requiring the payor to withhold U.S. tax on interest payments made throughout its taxable year, does not make the tax discriminatory.

The Print goes on, however, to state:

> If, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty.
>
> Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found to exist. Therefore, the bill provides that except as otherwise provided by the bill or the Act, the provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). If any such now-unknown conflict is ultimately found, it is expected that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is appropriate.

Finally, the Print states: "In addition, this technical corrections bill is understood not to conflict with any treaty. Again, should a conflict ultimately appear, the bill's provisions are to take effect."

In short, the intention is to override treaty obligations with respect to known treaty/Code conflicts except in certain specific cases; to explain the "harmonious" relationship between treaties and statutory law in other instances but, to be on the safe side, to override treaties there too; and to impose statutory law in the case of treaty/Code conflicts not yet identified or known to exist.

There is no doubt, under the Constitution, that Congress has the power to override, and thus unilaterally abrogate, international agreements of the United States. However, the fact that this power exists does not justify its exercise in any particular case. There are some obvious implications to repudiating formal government-to-government commitments; such repudiations are clearly more than mere "technical corrections" to existing legislation.

The proposed treatment of the branch level tax on excess interest offers a clear illustration of the seriousness of the legislative action that has been proposed. That tax operates, in general, as follows: The amount of the deduction for interest expense allowable to a foreign corporation engaged in a U.S. trade or business is the product of a formula under Treasury Regulation § 1.882-5. The formula can and often does yield a deductible amount that is different from (greater or less than) the amount of interest actually paid and booked by the U.S. business. The tax on "excess interest" is, in effect, a tax on the amount by which the deduction, in a given case, exceeds the amount of the payment. As a technical matter, under Code section 884(f)(1)(B), the amount of the excess is treated as if it were interest paid to the foreign corporation by a wholly-owned domestic corporation. This approach implicates the "taxability" rules of the Code and U.S. treaties; the excess interest may or may not be taxable depending on whether it is considered a bank deposit, interest on portfolio debt, or interest qualifying for a reduced rate of tax or exemption under a U.S. tax treaty. (The rules for "tracing" the excess interest to these various categories of debt are presently unclear; but presumably the issues presented here can be resolved through Treasury regulations in due course.)

The tax on "excess interest" raises several issues under U.S. tax and other treaties. Because section 884(f)(1)(B) is a fiction -- there is only one corporate entity in question, not two -- the tax arguably places a burden on a foreign corporation that a comparable U.S. corporation is not required to bear. On this view, the tax is discriminatory. The Joint Committee Print argues that the burden on the foreign corporation is no greater than the combined burden on a U.S. corporation and a foreign lender. This argument appears to be a dubious basis for a finding of nondiscrimination under international standards, but that is beside the point. We will never know whether the Technical Corrections Act conflicts with treaty nondiscrimination guarantees if the Act overrides all of those guarantees.

It is also arguable that "excess interest" does not have a U.S. source under treaties corresponding to the U.S. Model Income Tax Convention. The discussion at page 1042 in the General Explanation of the Tax Reform Act of 1986 is apparently to the contrary, but the point has never been adjudicated. What authority and commentary does exist suggests that interest must be linked to a U.S. business in some way other than deductibility in order to be sourced in the United States. Again, the question whether the General Explanation is correct here is less important than the apparent intention to enforce the staff's view through abrogating U.S. treaty commitments if the General Explanation should be wrong.

The Tax Reform Act of 1986 overrode treaties in numerous places, on a much more widespread basis than prior legislation. In many instances, however, these overrides were in the name of tax policy concerns either having some urgency or, at least, having relevance principally to U.S. persons (whom U.S. tax treaties are not generally intended to benefit). Thus, the overrides with respect to the new foreign tax credit rules are at least understandable. Similarly, the overrides in the case of the branch level tax, which prior to the Technical Corrections Act were limited to cases of treaty shopping, are also understandable. Congress evidently decided that treaty shopping is a pressing concern, and that the time required to renegotiate the U.S. treaty network to prohibit treaty shopping is simply too long to tolerate. U.S. treaty partners doubtless did not appreciate the unilateral repudiation of U.S. treaty commitments in the 1986 legislation, but they would be hard pressed to defend treaty shopping in general or, at least, to fail to appreciate the reasons for the Congressional action.

The Technical Corrections Act override for the tax on excess interest is not, however, limited to treaty shopping nor is it easily comprehensible. It would apply to all taxpayers who are not treaty shoppers and who operate in the United States in branch form (principally, but not solely, banks, which are the entities most affected by Treasury Regulation § 1.882-5). Many of these entities are publicly owned in their home countries and have their principal offices in those countries. They are not tax evaders. In general, their home countries impose taxes which are at least the equal of those in the United States. Moreover, the tax on excess interest would be the only piece of the branch level tax regime that would override treaty commitments in cases other than treaty shopping. Thus, if the Technical Corrections Act as it stands is enacted, the Code will not prohibit treaty shopping at all (will defer to treaties completely) in the case of U.S. subsidiaries; it will apply all aspects of the branch level tax regime with respect to treaty shoppers despite treaties; and it will apply the tax on excess interest to non-treaty shoppers despite treaties. The policy rationale for this patchwork scheme is difficult to discern.

Of course, it is not generally in the interests of the United States to override international agreements. Such overrides hardly comport with our professed allegiance to the rule of law. Not only do such actions have a tendency to inhibit the obtaining of new agreements in the future; they also undermine the word of the United States as expressed in international arenas more generally. Nor are any of these effects necessarily confined to the area of taxation, just because the abrogation is so confined.

But especially in the area of taxation, where the potential for counter-actions against U.S. interests is ever present, it makes little sense for the United States to disregard agreements that were struck in order to benefit the United States and its citizens and residents. Particularly in the area of discrimination, the United States has worked hard for many years to secure commitments from other countries, and one of the principal tools in this effort has been the nondiscrimination clause commonly found in tax and investment treaties. It is unwise for the United States to override such clauses.

A great deal of recent U.S. tax policy is driven by an obvious need for revenue. Whether the current budget situation justifies a disregard for long-standing, internationally shared principles of international taxation is, however, doubtful. In the case of the tax on "excess interest" such a disregard is peculiarly misplaced, since foreign banks can avoid additional tax costs by restructuring so as to fund U.S. operations from the United States. This may involve other, non-tax costs, but it is possible. If it is done, imposition of the tax on excess interest despite treaties will not produce additional revenues, yet the harm to U.S. stature in international tax matters will be no less.

Although most of this letter has focused upon the tax on "excess interest," similar observations could be made with respect to other Technical Corrections Act provisions relating to treaties, and especially other overrides of the nondiscrimination clause. The core issue here is not any particular statutory provision but a matter of general principle: Abrogations of treaty commitments are serious business. They should not be adopted simply because, at a given moment, Congress believes a particular tax policy is preferable to the one it followed in the past. They should require compelling justification. There is no such justification here.

Sincerely,

H. David Rosenbloom

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United States Council for International Business

Serving American Business as U.S. Affiliate of

The International Chamber of Commerce
The International Organisation of Employers
The Business and Industry Advisory Committee to the OECD
The ATA Carnet System

July 16, 1987

Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Oh behalf of the United States Council for International Business, I am pleased to respond to your request for comments on the pending Technical Corrections Bill (H.R. 2636). The United States Council for International Business is comprised of some 300 major corporations, law firms, and accounting firms with substantial experience in foreign operations of U.S. entities. The Council represents American business in the major international economic institutions such as the OECD and the International Chamber of Commerce.

We are concerned about action proposed to be taken with respect to the interaction of provisions of the Internal Revenue Code and obligations under U.S. income tax treaties with other nations, including statements in the explanation of the bill that suggest an abandonment of long standing principles governing U.S. compliance with treaties.

We do not believe that changes in U.S. commitments to international agreements should be considered as mere technical corrections. We refer specifically to proposed legislation affecting presumptions as to whether inconsistent treaty or statutory rules should prevail; the overriding of existing treaty provisions in possible future conflicts that have not been identified; and the interpretations of treaty nondiscrimination provisions that could, if adopted by others, significantly undercut treaty protection for U.S. companies and their subsidiaries against discriminatory tax laws of foreign countries. We propose, therefore, that section 112(y) (Coordination with Treaties) be deleted from the bill.

We note that the Subcommittee on Oversight of the Ways and Means Committee has announced that it will hold hearings on tax treaties, including "the consistency of the terms of such treaties with U.S. tax laws" and we urge that the topic of the interrelationship of treaty rules and legislation be addressed at that hearing with the care that such an important question should receive.

Very truly yours,

Richard M. Hammer

Richard M. Hammer
Chairman
Committee on Taxation

Robert J. Patrick, Jr.

Robert J. Patrick, Jr.
Vice Chairman
Committee on Taxation

Section 1246

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August 10, 1987

Janice Mays
House Ways and Means Committee
1111 Longworth House Office Building
Washington, DC 20515

Re: Section 1446

Dear Ms. Mays:

This letter sets forth some apparent incongruities in the application of § 1446* of the Code relating to withholding by partnerships on distributions to foreign partners. I believe that these points would be appropriate subjects for H.R. 2636 (the "Technical Corrections Act").

Introduction

The Code establishes two different regimes for the taxation of a foreign person's income, one (the "ECI regime") applicable to the extent that the foreign person has income which is effectively connected with the conduct of a trade or business in the United States ("ECI") and the other (the

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* All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended (the "Code").

"passive income regime") applicable to other types of U.S. source income which are passive in nature, including fixed or determinable annual or periodic income ("FDAP income") and capital gains.* Since 1966 when the automatic "force of attraction" principle of prior law was eliminated, the Code has recognized that a single foreign person may have income subject to both regimes.** Under the ECI regime a foreign taxpayer is required to file a return and compute tax on taxable income generally in the same manner as a U.S. person. Under the passive income regime a foreign person files no return but is subject to tax in the form of withholding on the gross amount of FDAP income, while capital gains are not subject to tax. Prior to 1987, a partnership was required to withhold under § 1441 and § 1442 on a foreign partner's distributive share of FDAP income, and a foreign partner was responsible for filing a return and paying tax on its distributive share of ECI. As under current law, no tax was imposed on capital gain income.

Section 1446 was added to the Code by § 1246(a) of the Tax Reform Act of 1986 (the "1986 Act") in response to Congressional concern that the tax imposed under the ECI regime was not generally being collected in the case of partnerships. The new section establishes a withholding tax on partnership distributions which is intended to assure the collectibility of at least a portion of the tax which the Code imposes upon a foreign partner's share of ECI. Section 1446 thus compliments the withholding tax under §§ 1441 and 1442 which is applicable under the passive income regime. Section 1446 does not have any effect upon the imposition or calculation of tax, either under the ECI regime or the passive income regime. Therefore, except to the extent that it results in collection of tax on ECI which otherwise would have been avoided, § 1446 has no effect upon federal government revenues.

Despite its salutary purpose § 1446 contains at least two serious technical flaws which, if not corrected, will have the effect of imposing a withholding obligation on partnership distributions that are not even remotely related to Congress's desire to backstop the ECI regime. Specifically, § 1446 should be corrected in the following manner: i) by clarifying under § 1446(c)(2) that distributions to a foreign partner to whom the partnership allocates no ECI are not subject to withholding; and ii) by clarifying under § 1446(c)(1) that the § 1446 withholding requirement excludes not only distributions of FDAP income but also distributions of other amounts which could not be subject to federal income tax, e.g., interest on tax exempt bonds, capital gains and returns of capital.* Correction of § 1446 in this manner would have no effect upon revenue, because the nature of the technical corrections would only be to prevent withholding upon amounts which are clearly not subject to tax and therefore are eligible for a full refund.

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* References in this letter to FDAP income and capital gains, unless otherwise indicated, assume that such amounts do not constitute ECI.

** Section 864(c)(2) establishes detailed rules for determining whether or not U.S. source FDAP income and capital gains are ECI.

Section 1446(c)(2)

Section 1446(c)(2) provides an exception to the withholding obligation which is generally intended to apply to partnerships in which foreign partners do not have an economic interest in the partnership activities or items of income which are taxable under the ECI regime. It provides:

> "(2) Partnerships with Certain Allocations. - Except as provided in regulations, subsection (a) shall not apply to any partnership with respect to which substantially all income from sources within the United States and substantially all income which is effectively connected with the conduct of a trade or business within the United States is properly allocated to United States persons."

The language of § 1446(c)(2) is overreaching in two respects, however. First, because the requirement that ECI be allocated away from foreign partners fully protects the tax base at which § 1446 is aimed, the requirement of allocating all U.S. source income away from foreign partners is inappropriate. Second, the exception would operate in a more reasonable and effective manner if its operated on a partner-by-partner basis (i.e., exempting distributions to a particular foreign partner if the partnership allocates no U.S.

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* The current draft of the Technical Corrections Act would ameliorate certain technical problems relating to the same provisions discussed in this letter but would not go far enough to solve all of the problems.

income to that foreign partner) rather than operating on the partnership as a whole.

The following example will serve to illustrate these problems. Suppose that an investment partnership holds two types of assets. The first is stock of a U.S. domestic corporation which pays regular dividends which are U.S. source income and therefore are subject to FDAP withholding. The second is a limited partnership interest in a second partnership which is carrying on an active trade or business and thus gives rise to ECI. There are three partners: F1 and F2 (both foreign partners) and R (a U.S. individual resident). The partnership agreement provides for all income, gain, loss and distributions attributable to the stock investment to be allocated equally among the three partners and for all such items attributable to the lower tier partnership to be allocated equally between F2 and R. Thus, F1 has no economic interest in the lower tier partnership. The foregoing allocations comply in all respects with the requirements of § 704(b). Distributions to F1 attributable to dividends on the stock are subject to FDAP withholding and accordingly are not subject to § 1446 withholding, pursuant to the rule of § 1446(c)(1). If the partnership were to sell the stock, however, and distribute the proceeds, the distribution to F1 of his share of the proceeds (both the portion which is a return of capital and the portion, if any, which is capital gain) appears to be subject to withholding under § 1446.

It seems obvious that the distribution of the sale proceeds to F1 should not be subject to withholding, given the purpose of § 1446(c)(2). Under the partnership agreement F1 has no interest whatever in any ECI of the partnership. Yet, because § 1446(c)(2) requires allocating not only ECI but all U.S. source income away from the foreign partners, withholding is apparently required.

The language of § 1446 is derived from the Senate bill (H.R. 3838, 99th Cong. 2d Sess.) (May 6, 1986) (the "Senate Bill"). There is no language in the legislative history* explaining why the § 1446(c)(2) exception requires allocating U.S. *source* income away from foreign partners in addition to ECI. Indeed, the Senate Report states at p. 414 that "the Committee believes that all *effectively connected income* earned by foreign persons through U.S. partnerships should be subject to U.S. withholding tax to insure collection of such persons' U.S. income tax liability" (emphasis added). Section 1446 specifically contemplates that a partnership may have U.S. source FDAP income as well as ECI, and yet does not impose § 1446 withholding on the U.S. source FDAP income. Rather, the statutory scheme requires FDAP withholding on distributions attributable to the FDAP income and § 1446 withholding on distributions attributable to the ECI (§ 1446(c)(1)). To require that all U.S. source income (including FDAP income and capital gains) be allocated away from the foreign partners is inconsistent with that statutory scheme. Section 1446(c)(2) should only require that ECI be allocated away from foreign partners, not all U.S. source income.

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* Relevant legislative history is contained in the Senate Finance Committee report, S. Rep. No. 99-313, 99th Cong. 2d Sess. (1986) (the "Senate Report"), pp. 413-15, the Conference Committee Report, H. Rep. 99-841, 99th Cong. 2d Sess. (September 18, 1986), pp. II-653-54, and the General

Furthermore, it is hard to see why the § 1446(c)(2) exception should require allocating ECI away from *all* foreign partners. In the example above, it is clear that F1 has no share of ECI; presumably F1 should not be subject to § 1446 withholding simply because F2 shares in ECI. Although there may be situations in which the validity of allocations under § 704(b) is uncertain, this potential uncertainty is already built into § 1446(c)(2) and would not be exacerbated by recognizing separate sub-classes of foreign partners.

The illogic of requiring withholding in these cases is demonstrated by the fact that F1 would be entitled to file a tax return showing ECI of zero, reflecting the withheld tax as a payment and claiming a refund of the entire amount. There is no apparent reason to impose the administrative burden of this awkward procedure upon both the government and the foreign partner.*

Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation (May 4, 1987), pp. 1054-56.

* The experience of recent years relating to FDAP withholding and "backup" withholding in respect of interest paid by U.S. obligors demonstrates the extreme sensitivity of foreign investors to withholding requirements which go beyond what is reasonably necessary to effectuate their purpose.

The rule of § 1446(c)(2) could be rationalized if it were amended to read as follows:

> "(2) Partnerships with Certain Allocations. - Except as provided in regulations, subsection (a) shall not apply to any distribution to any partner which is not a United States person by any partnership with respect to which [substantially all income from sources within the United States and] substantially all income which is effectively connected with the conduct of a trade or business within the United States is allocable under section 704 to [United States] persons other than the distributee."*

Section 1446(c)(1)

The foregoing example points to the other major technical flaw in § 1446 which should be corrected. Section 1446(c)(1) properly contemplates that a partnership may have income which is subject to the passive income regime and therefore should not be subject to § 1446 withholding. It provides:

> "(1) Amounts on Which Tax Withheld. - Subsection (a) shall not apply to that portion of any distribution with respect to which a tax is required is to be deducted and withheld under section 1441 or 1442 (or would be required to be deducted and withheld but for a treaty)."

The Technical Corrections Act appropriately expands that provision to cover certain other types of income not explicitly referred to in the existing language, viz. portfolio interest and interest on bank deposits. Even as corrected, however, the language would be anomalous in that it would not protect certain other types of distributions relating to passive income, including those which are attributable to capital gain transactions and to tax exempt interest income. In the foregoing example, the partnership might sell the stock it holds as an investment and distribute the entire proceeds, consisting of a return of capital and a capital gain (if any), to its partners. Section 1446 appears to require withholding on the entire amount of the distribution to both F1 and F2, even if the transaction has resulted in a capital loss. Again, both F1 and F2 would presumably be entitled to file U.S. tax returns and claim refunds of the amount withheld, because no tax is imposed by the Code in respect of these transactions.

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* The underscored language represents additions; the bracketed language deletions. The language also embodies the specific reference to § 704 contained in § 112(q)(1) of the Technical Corrections Act.

Section 1446(c)(1) could be corrected in this respect if it were changed to read as follows:

> "(1) Amounts on Which Tax Withheld. - Subsection (a) shall not apply to that portion of any distribution attributable to any amount not subject to the tax imposed by this subtitle or with respect to which a tax is required is to be deducted and withheld under section 1441 or 1442 [or would be required to be deducted and withheld but for paragraph (9) or (10) of section 1441(c) or a treaty]."*

The foregoing change would complete the scheme of § 1446(c)(1) to separate the passive income regime from the ECI regime for withholding purposes. It would prevent the anomaly (among others) of a partnership's withholding nothing in respect of distributions attributable to portfolio interest on a U.S. obligor's debt obligation but having to withhold at 20% upon distributions attributable to the redemption of that same obligation. Such a change would appear to be fully consistent with the Technical Corrections Act's notion that the 20% withholding should not apply to items which are not subject to U.S. tax.

Other Considerations

It is important to acknowledge in this context that both the existing structure of § 1446 and its structure if amended give rise to certain potential ambiguities. First, there may be circumstances in which it is difficult to ascertain under § 864(c)(2) whether a particular item of FDAP income or capital gain is ECI. Second, § 1446 requires a determination of the extent to which a particular partnership distribution is attributable to a particular item of income, gain, etc.* Although there are many situations, particularly in the case of an investment partnership which generally distributes cash to its partners promptly upon receipt, in which it is relatively simple to attribute the distributions, one can imagine other situations in which that attribution is not simple.

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* The proposed new language would make the existing parenthetical language superfluous.

Neither of these potential ambiguities should preclude making the corrections suggested in this letter, however. As to both, the government has the substantial revenue protection which is built into any withholding tax, i.e., because the withholding agent is personally liable for the tax, he is generally forced to resolve all doubts in favor of the government. Furthermore, these potential ambiguities are already implicit in § 1446 because of its treatment of FDAP income, and there is no rational basis for distinguishing capital gains or other exempt income in this respect.

The resolution of how to attribute distributions to particular items of income seems to be an appropriate subject for regulations. Those regulations might be based upon the notion (apparently contemplated by the legislative history of § 1446) that distributions are first attributable to passive income, or might establish a proration of distributions among a partnership's various sources thereof, or might even establish a presumption that ECI is distributed first, in order to assure the collection of tax which is the purpose of § 1446. Application of these rules would probably require maintenance by the partnership of special subdivisions of the capital accounts for each class of partners, somewhat akin to corporate earnings and profits accounts, but divided between ECI items and passive income items. These accounts could be derived directly from the information return and K-1 forms which the partnership is required to prepare.

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* Section 1446(c)(1) does not use the phrase "attributable to" specifically but rather refers to "that portion of any distribution with respect to which" FDAP withholding is required. Nonetheless, this language presents the same potential ambiguity described above, because the Code has never attempted to articulate precisely the extent to which partnership distributions are attributable to FDAP income. See, Treas. Reg. § 1.1441-3(f) ("[a partnership] shall withhold under this section on all distributions to [foreign] partners . . . to the extent such distributions include items of [FDAP] income" (emphasis added)).

Accounts of this type are possible because withholding under § 1446 is materially different from various other kinds of withholding in one important respect. Most withholding rules are designed to operate in an extremely simple fashion; they create "rough justice" in situations where the withholding agent as a practical matter cannot be expected to have sufficient information to calculate a withheld amount which is precisely tailored to the recipient's tax circumstances. This principle does not need to be rigorously applied in the case of partnership withholding, because the partnership has very specific knowledge as to the nature of the income, gains, etc. in which a foreign partner has participated. Indeed, the partnership information return and form K-1's put the partnership in the position of having better access to information than the foreign partner himself. Thus, for example, the partnership should have no particular difficulty ascertaining whether there has been any ECI or whether ECI has been allocated to a foreign partner. Given this intimate knowledge of the transactions which give rise to the tax liability, it seems appropriate in the context of § 1446 for regulations to permit the partnership to delineate those distributions attributable to ECI from those which are not. As indicated above, the partnership will be liable as withholding agent for any erroneous determinations it may make and thus will have a strong built-in incentive to protest the revenue base.

Summary

For the reasons discussed above, it is important to correct § 1446 so that it operates in a rational way with respect to a foreign partner's distributive share of partnership income. The statute clearly contemplates that a partnership may have some income which is ECI and other income which is not and also that a partnership can effectively allocate certain types of income away from foreign partners. The changes suggested in this letter would correct the operation of § 1446 so that it serves its appropriate purpose, i.e. to assure that foreign partners pay a tax on their share of ECI, but does not cause undue administrative burdens and potential hostility in international financial markets by forcing withholding in respect of amounts which are clearly not subject to tax. These changes would cause no ultimate reduction in revenue.

I shall be happy to discuss these matters further with you or with members of your staff.

Very truly yours,

William H. Weigel

William H. Weigel

Title XIII
Comments on more than one section (includes mention of Sections 252 and 902)

WILLIAM A. O'NEILL
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July 17, 1987

Robert Leonard
Chief Counsel
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Earlier this month, the Ways and Means Committee invited the public to submit comments on H.R. 2636, the Technical Corrections Act of 1987. For your information, I have attached six copies of a letter from Anthony Milano, Secretary of the Connecticut Office of Policy and Management, to Representative Barbara Kennelly. This letter outlines several issues in the area of tax-exempt bonds which are of major concern to the state.

Once again, we appreciate the opportunity to comment on the bill. Please let us know if you have any questions or need further information.

Sincerely,

Ann L. Sullivan
Ann L. Sullivan

Attachments

STATE OF CONNECTICUT
OFFICE OF POLICY AND MANAGEMENT

July 17, 1987

The Honorable Barbara B. Kennelly
U.S. Representative
1230 Longworth House Office Building
Washington, D.C. 20515

Dear Barbara:

With regard to the Technical Corrections Act of 1987, I would like to thank you and your staff for the hard work you have put in to insure that Connecticut will be able to take advantage of its special tax-exempt bond provision. This section will grandfather bonds which have been authorized but not issued by the State Bond Commission. In addition, I would like to note our pleasure in the changes in the low income housing tax credit and the extension of the authority to undertake current refunding of Mortgage Revenue Bonds. This extension will allow the continued financing of CHFA's Home Mortgage Loan program separate from the statewide volume limit of "private activity" bonds.

Although there are issues created by the Tax Reform Act of 1986 which the State would like to see altered, the desired changes are more fundamental than the opportunities provided in technical corrections. Therefore, I urge you and your colleagues to pass the Technical Corrections Act of 1987 as expeditiously as possible. When the opportunity arises for us to provide input into changes in the bonding provisions or the other provisions affecting housing development, the State would like to participate.

I look forward to when our offices can again work together to the ultimate benefit of Connecticut.

Sincerely,

Tony

Anthony V. Milano
Secretary

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Summary of Requested Action

Essex County, New Jersey requests that a change be made to the Technical Corrections Act of 1987 to obtain relief from Section 113(d)(1) with respect to its $25,000,000 of General Obligation Refunding Bonds issued on April 28, 1987 to refund a portion of $48,000,000 of its bonds issued on May 9, 1985 to purchase an annuity contract to pay pension liabilities.

General Background

In the 1960's the Employees' Retirement System ("ERS") of Essex County, New Jersey (the "County") was closed to new membership (all new employees then became members of state administered pension plans).

The continuing employer contributions to be made by the County were determined by a state statutory formula. Over the years the County made those contributions. Unfortunately, the formula was not actuarily sound and in time a large deficiency developed. The County was liable to pay the pension benefits regardless of whether the formula contributions were adequate.

In May 1985 the County issued $48 million of tax-exempt general obligation bonds (the "1985 Bonds"). The net proceeds of the 1985 Bonds were used to purchase from Metropolitan Life Insurance Company a lump sum annuity which covered the County's pension obligations to approximately 1100 retired ERS members. Prior to issuing the 1985 Bonds, the County obtained a private letter ruling from the Internal Revenue Service which concluded that the 1985 Bonds would not be arbitrage bonds where, pending payment of retirement benefits to the ERS members covered by the annuity, the annuity premium was invested by the annuity provider at a yield materially higher than the yield on the County's financing. Kraft & Hughes, Newark, New Jersey, served as bond counsel; First Fidelity Bank, N.A., New Jersey, (the "Bank") underwrote the 1985 Bonds; and Donovan Leisure Newton & Irvine, New York, New York, served as underwriter's counsel.

Commencing in the Spring of 1986, the Bank, on behalf of the County, began tracking the feasibility of an advance refunding of the callable 1985 Bonds to effect a debt service reduction based on lower interest rates. In October 1986, an application was filed with the New Jersey Local Finance Board on behalf of the County for the proposed issuance of tax-exempt refunding bonds, the net proceeds of which would advance refund the callable 1985 Bonds. The present County administration has no indication that the prior County administration was at any time advised during this period by either its bond counsel, or any other party connected with the proposed issuance of refunding bonds, that the Tax Reform Act of 1986 might in any way preclude the issuance of tax-exempt bonds to refund the 1985 Bonds.

In the November 1986 election, County Executive Peter Shapiro lost his bid to retain County office. In January 1987, a new County administration headed by Nicholas R. Amato, County Executive, was installed in the County and McCarter & English, Newark, New Jersey, was appointed as bond counsel to the County. During the Spring of 1987, discussions took place with various government personnel concerning the proper application of the arbitrage rules of the Tax Reform Act of 1986 to bonds issued to refund obligations used to purchase an annuity contract. Personnel with Tax Legislative Counsel thought that a refunding of bonds issued prior to September 26, 1985, such as the 1985 Bonds, which were invested in an annuity contract with a materially higher yield, was permitted under the Tax Reform Act of 1986. Personnel with the Joint Committee on Taxation thought that the legislative intent was to not permit such refundings.

In April 1987, the County made a public offering of its $25 million General Obligations Refunding Bonds (the "Refunding Bonds"). The Refunding Bonds were issued on April 28, 1987 and the net proceeds were utilized to advance refund the callable portion of the 1985 Bonds. The County realized a present value budgetary savings, by virtue of reducing its interest rate, of almost $1 million. Donovan Leisure Newton & Irvine issued the opinion as to exemption of interest on the Refunding Bonds from federal income taxation; McCarter & English issued the opinion covering the validity of the Refunding Bonds under State law and the State tax opinion; the Refunding Bonds were underwritten by the Bank, which was represented by Salerno & Lunga, Verona, New Jersey.

The Tax Reform Act of 1986 and the Technical Corrections Act of 1987

Sections 148 and 149(d) of the Internal Revenue Code of 1986 (the "1986 Code"), as added by Section 1301 of the Tax Reform Act of 1986, impose various arbitrage restrictions with respect to the investment of "proceeds" of refunding bonds and refunded bonds, including the requirement contained in Section 149(d)(3)(A)(v) of the 1986 Code that as of the date of the refunding, proceeds of the refunded issue (with certain exceptions) are to be invested at a yield not materially higher than the yield on the refunded issue, and the requirement that as principal of the refunded issue is paid with the refunding issue, that proceeds of the refunded issue become proceeds of the refunding issue and the investment of such proceeds are thereby restricted to a yield not materially higher than the yield on the refunding bonds (which in a high-to-low refunding would result in a lowering of the permissible investment yield). All such rules, however, apply only to proceeds of the bonds which are not considered "spent". Under the Internal Revenue Code of 1954, as amended, applicable to the 1985 Bonds since such Bonds were issued prior to September 26, 1985, proceeds of bonds were considered spent and therefore no longer subject to arbitrage restrictions if they were used in a manner other than to purchase securities or debt obligations, or held as cash. In accordance with the private letter ruling received with respect to the 1985 Bonds, the proceeds of the 1985 Bonds were considered used to purchase an annuity contract with a third party which was not a security, debt obligation or cash and, accordingly, was not subject to arbitrage restrictions. Such proceeds were instead considered spent upon purchase of the annuity contract.

Section 148 of the Code, as added by Section 1301 of the Tax Reform Act of 1986, expands the uses of bond proceeds subject to arbitrage restrictions to encompass investments in "investment property", including for the first time "annuity contracts" and "investment-type property." Accordingly, the proceeds of bonds issued after the pertinent effective dates of the Tax Reform Act of 1986 which are invested in either annuity contracts or investment-type property will no longer be considered spent proceeds under the Tax Reform Act. Neither the language of the Tax Reform Act of 1986 nor the Conference Agreement, however, give any indication that the new rules governing investments in annuity contracts or other investment-type property are to apply to amounts which were already considered spent under prior law.

Instead, the new arbitrage restrictions applicable to investments in annuity contracts and other investment-type property were appropriately read as being relevant solely to bond proceeds not considered spent under prior law and which were existing subsequent to the effective date of the new arbitrage provisions. As concluded hereafter, the statement in the Conference Agreement at page 749 that "the restriction on investment in annuity contracts applies to bonds (including refunding bonds) issued after September 25, 1985" was intended to convey an entirely different meaning than that previously spent proceeds should be "unspent".

The first written indication that Congress had intended a reading of the Tax Reform Act of 1986 different from the position taken with respect to the Refunding Bonds was contained in the General Explanation of the Tax Reform Act of 1986, dated May 4, 1987 (one week after the Refunding Bonds were issued), at page 1202, where it was stated that:

> Congress intended this provision [relating to "annuity contracts"] to prohibit issuance of refunding bonds (as well as new issues) of pension arbitrage bonds after September 25, 1985, regardless of whether the proceeds of the refunded bonds used to acquire the annuities may have been treated as spent proceeds.... [emphasis added]

However, footnote 155, immediately following this sentence, states that:

> A technical amendment may be necessary for the statute to reflect this intent.

thereby acknowledging that the language of the Tax Reform Act of 1986 did not effectuate the purported Congressional intent, *i.e.*, subjecting proceeds deemed "spent" under the 1954 Code to the new provision of the Tax Reform Act relating to annuity contracts.

Section 1314(a) of the Tax Reform Act of 1986 currently provides as follows: "Arbitrage Restrictions on Investments in Annuities - In the case of a bond issued after September 25, 1985, section 103 of the 1954 Code shall be applied by treating the reference to securities in paragraph (2) thereof as including a reference to an annuity contract." On June 10, 1987 the Technical Corrections Act of 1987 was introduced in Congress. Section 113(d)(1) states that: "Subsection (a) of section 1314 of the Reform Act is amended by adding at the end thereof the following: 'The treatment under the proceeding sentence shall also apply to a bond issued before September 26, 1985, but only for the purposes of determining whether any bond issued to advance refund such bond (or a bond which is part of a series of refundings of such bond) is an arbitrage bond (within the meaning of Section 148(a) of the Code)'".

The Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) (the "Joint Committee Description") released on June 15, 1987 states at page 252 that: "The bill clarifies that the arbitrage restrictions on investment in annuity contracts prohibits advance refundings (as well as new issues) of so-called 'pension bonds' after September 25, 1985." [emphasis added]

Section 119 of the Technical Corrections Act of 1987 states as follows: "Effective Date. Except as otherwise provided in this title, any amendment made by this title shall take effect as if included in the provision of the Reform Act to which such amendment relates." Since no specific effective date provision is given with respect to Section 113(d)(1), the general effective date provisions of Section 119 would apply, which would render an effective date for such provision of September 26, 1985.

Reasons for Amendment

1. Prior to the release of the General Explanation, there was no legislative history to contradict the view that refundings such as was accomplished by the Refunding Bonds were permitted under the Tax Reform Act of 1986.

2. Section 113(d)(1) of The Technical Corrections Act of 1987 does not merely "clarify" the Tax Reform Act of 1986 as indicated in the Joint Committee Description. Rather, such section constitutes a major substantive change:

> (a) Enactment of Section 113(d)(1) of The Technical Corrections Act of 1987 would seemingly result in a dichotomy of treatment with respect to advance refundings of pre-September 26, 1985 bonds invested in annuity contracts versus advance refundings of pre-August 15, 1986 bonds invested in other investment-type property. Advance refundings of such pension bonds would be prohibited because the proceeds of the prior issue, for purposes of determining whether the refunding bonds are arbitrage bonds, would no longer be considered spent, while advance refundings of bonds invested in other investment-type property would be permitted because the proceeds of the prior issue so invested would be considered spent. In the Conference Agreement, at page 749, the explanation of effective dates with respect to both of the described transactions uses identical language, i.e., "(including refunding bonds)."
>
> (b) Enactment of Section 113(d)(1) of The Technical Corrections Act of 1987 would also result in a dichotomy of treatment with respect to current refundings of pension bonds versus advance refundings of pension bonds. This distinction is nowhere in evidence in the Tax Reform Act of 1986 or its legislative history. As noted, the Conference Agreement merely uses the phrase "(including refunding bonds)".
>
> (c) The Conference Agreement at page 749 uses the same parenthetical "(including refunding bonds)" in explaining the effective date for the new method of determining bond yield under the Tax Reform Act of 1986. While Section 113(d)(1) of The Technical Corrections Act of 1987 would require that investments of proceeds of prior bonds be characterized as spent or not spent based on the new law, there has been no suggestion in the legislative history that in an advance refunding of an advance refunding, the yield of the prior bonds must be recomputed based on the new methodology for determining yield for purposes of the requirement contained in Section 149(d)(3)(A)(v) that after the date of issuance of the advance refunding bonds, the yield on investments of proceeds of the prior issue (with certain exceptions

> for reserve funds, temporary periods and minor portion) be invested at a yield not materially higher than the yield on the prior issue. Since it would generally be impossible to restructure prior escrow investments, adoption of such requirement of recomputation of prior bond yield would necessarily preclude most advance refundings of advance refundings, a result clearly not contemplated by the Tax Reform Act of 1986 since Sections 149(d)(3)(A)(i)(II) and 149(d)(6)(B) of the 1986 Code permit multiple advance refundings. Again, the Conference Agreement uses the same phraseology, "(including refunding bonds)" in describing the effective dates with respect to both provisions.

Accordingly, the phrase "(including refunding bonds)" in the Conference Agreement, as applied to each of the three effective date provisions discussed above, was merely meant to constitute a generalized statement that the arbitrage provisions of the Tax Reform Act apply to all refunding bonds issued after those effective dates, regardless of whether the refunded bonds were issued before such effective dates.

3. Although McCarter & English, the newly-appointed bond counsel of the recently-installed County administration, did not render a tax-exemption opinion for the Refunding Bonds, such counsel was of the view that the opinion of Donovan, Leisure, Newton and Irvine, special tax counsel, was reasonable. The current County administration had no indication that the bond counsel of the County's prior administration raised any tax objections to the issuance of the Refunding Bonds. Moreover, the County had determined that another well-known law firm, in addition to Donovan, Leisure, Newton & Irvine, was willing to render a favorable opinion with respect to the annuity contract issue. Under these circumstances, it was perfectly reasonable for the County to proceed with the transaction.

4. The County obtained a private letter ruling with respect to the 1985 Bonds which indicated that such bonds would not be arbitrage bonds by virtue of the purchase of an annuity contract with the proceeds of the 1985 Bonds. Accordingly, the County could and did regard the issuance of the Refunding Bonds as a traditional general obligation refunding issue whose purpose was to achieve nothing more than present value debt service savings by taking advantage of lower market interest rates.

5. Section 113(d)(1) of the Technical Corrections Act of 1987 would require the County to rebate to the United States the difference between the yield on the annuity contract and the yield on the Refunding Bonds, not merely the difference between the yield on the 1985 Bonds and the yield on the Refunding Bonds. Thus, such rebate amount would include not only the benefit resulting from the issuance of the Refunding Bonds but also the benefit resulting from the issuance of the 1985 Bonds, notwithstanding that the 1985 Bonds were issued pursuant to a private letter ruling. The benefit resulting from the issuance of the 1985 Bonds (which would be rebatable) was several multiples in excess of the benefit resulting from the issuance of the Refunding Bonds.

6. The Refunding Bonds are not callable for any reason prior to June 15, 1997. Accordingly, the impact of Section 113(d)(1) of The Technical Corrections Act of 1987 could not be mitigated by calling the Refunding Bonds. Because the County is already in a deficit cash-flow position, additional payments to

bondholders due to enactment of Section 113(d)(1) of The Technical Corrections Act of 1987 might have to come from County borrowings (possibly taxable borrowings, if such borrowings would themselves be considered part of a series of refundings of the 1985 Bonds.)

Recommended Amendment

The County requests a change in the Technical Corrections Act of 1987 which would prevent Section 113(d)(1) of the Technical Corrections Act of 1987 from having any effect on the tax exemption of the County's Refunding Bonds. It is suggested that such change could follow one of three alternatives.

Alternative 1

Section 1317(15) of the Tax Reform Act of 1986 currently exempts four issues of bonds from the treatment of annuity contracts as investment property under Section 148(b)(2) of the 1986 Code. If Section 113(d)(1) of the Technical Corrections Act were adopted in its present form, the Refunding Bonds would avoid its detrimental effect if the Technical Corrections Act of 1987 were amended by adding the Refunding Bonds to the group of bonds exempted under Section 1317(15) of the Tax Reform Act of 1986. This could be accomplished by an amendment to Technical Corrections which adds a new subparagraph (E) at the end of Section 1317(15) of the Tax Reform Act of 1986 which would provide that:

"(E) A bond is described in this paragraph if such bond was issued by Essex County, New Jersey on April 28, 1987 to refund bonds of the County issued on May 9, 1985.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $25,000,000."

Alternative 2

Another approach which would give the County the sought-after relief would be to provide an effective date for Section 113(d)(1) of the Technical Corrections Act of 1987 which made Section 113(d)(1) only applicable to advance refunding bonds issued after some date subsequent to the release of the General Explanation. The Committee Report would, in addition, clarify that bonds issued prior to the effective date of Section 113(d)(1) of the Technical Corrections Act of 1987 to advance refund pension bonds issued prior to September 26, 1985 are exempt from the annuity contract provisions.

Alternative 3

The third alternative approach would be to delete Section 113(d)(1) from The Technical Corrections Act of 1987.

Comments Submitted By:
John J. Scally, Jr., Esq.
McCarter & English
ON BEHALF OF
Essex County, New Jersey
Dated: July 17, 1987

NABL

NATIONAL
ASSOCIATION
OF BOND
LAWYERS

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HINSDALE, ILLINOIS 60522
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July 16, 1987

COMMENTS REGARDING
TECHNICAL CORRECTIONS ACT OF 1987

Set forth below are the comments of the National Association of Bond Lawyers regarding the tax-exempt bond provisions contained in the Technical Corrections Act of 1987, introduced on June 10, 1987. These comments are divided into three categories: (1) comments regarding the need for clarification of certain technical corrections; (2) comments regarding substantive change caused by certain technical corrections; and (3) comments regarding other required technical corrections.

As used herein, the term "Bill" means the Technical Corrections Act of 1987, introduced as S.1350 in the United States Senate and H.R. 2636 in the United States House of Representatives. The term "Act" means the Tax Reform Act of 1986. The term "1986 Code" means the Internal Revenue Code of 1986 as enacted by the Act. The term "1954 Code" means the Internal Revenue Code of 1954. The term "Explanation" means the "Description of the Technical Corrections Act of 1987," released by the staff of the Joint Committee on Taxation on June 15, 1987. The term "Blue Book" means the "General Explanation of the Tax Reform Act of 1986" released by the Staff of the Joint Committee on Taxation on May 8, 1987.

TECHNICAL CORRECTIONS REQUIRING FURTHER CLARIFICATION

Small Issuer Exemption from Rebate: Entities Formed for Application of Exemption. Section 113(a)(17)(A)(iii) of the Bill adds clause (ii)(III) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there must be included "an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of" the small issuer exemption from rebate. Clause (ii)(III) should be deleted from the amendment made by section 113(a)(17)(A)(iii) of the Bill.

The inclusion of clause (ii)(III) implies that citizens will form local government units with general taxing powers solely for the purpose of application of the $5,000,000 exemption from rebate. This is highly unlikely and, even if true, is not possible of determination. Formation documentation will not indicate purposes for formation beyond governmental purposes, bond counsel will not be capable of applying the provision and the Internal Revenue Service will not be capable of enforcing the provision.

Small Issuer Exemption from Rebate: Certain Current Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds clause (iii) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there shall not be taken into account "any bond issued to refund (other than advance refund) any bond to the extent the amount of the refunding bond does not exceed the outstanding amount of the refunded bond." (Emphasis added.) Application of the underlined phrase is unclear. If a refunding bond is issued in the amount of $4,000,000 to refund the $3,000,000 outstanding amount of a prior bond, does clause (iii) mean that the entire $4,000,000 refunding bond must be counted in determining the application of the exemption because the principal amount of the refunding bond exceeds the outstanding principal amount of the refunded bond? Or does clause (iii) mean that only $1,000,000 of the refunding bond must be counted in determining the application of the exemption? If the former meaning is intended, the word "if" should be substituted for the underlined phrase.

Change in Use Provisions Applied to Small Issue Private Activity Bonds Section 113(a)(23)(A) of the Bill amends section 150(b)(4)(B) of the 1986 Code by inserting the phrase "or a qualified small issue bond" indicating that the change in use provisions apply to terminate interest deductibility for small issue bonds in the case of facilities financed with such bonds "if such facility is not used for a purpose for which a tax-exempt bond could be issued on the date of such issue" (Section 150(b)(4)(A) of the 1986 Code). The Explanation indicates, as one example of a change in use for a small issue bond, a post-issuance capital expenditure which results in violation of the $10,000,000 limitation applicable to small issue private activity bonds. It is strenuously objected that such a capital expenditure is not a change in "use"; rather a change in use would result, for example, from use for a commercial purpose of a facility financed with bonds exempt by reason of an original use for a manufacturing purpose. If it is intended that violation of the $10,000,000 result in a loss of the interest deduction, Section 113(a)(23)(A) of the Bill should specifically so indicate.

Improper Code Reference. Section 113(c)(12)(A) of the Bill relates to an amendment to subparagraph (N) of section 103(b)(6) of the "1986 Code." The reference to the Code should be changed to the "1954 Code," as was done in section 113(c)(12)(B) of the Bill.

Extension of Origination Period for Current Refundings of Qualified Mortgage Bonds In discussion of the extension of the 1954 Code sunset date for issuance of qualified mortgage bonds and bonds issued to refund qualified mortgage bonds, the Explanation states on page 244, ". . . refundings permitted under this expansion of the transitional exception may not involve an extension of the period for providing financing to homebuyers." A similar statement was contained in the Conference Report, published September 18, 1986, on page II-716 and in the Blue Book on page 1230. The statement is not supported by specific statutory language in either the Act, the 1986 Code or the 1954 Code.

Congress, in both the 1986 Code and in the 1954 Code, placed certain limitations upon the type and amount of qualified mortgage bonds and mortgages acquired with qualified mortgage bonds, as well as certain limitations upon arbitrage earnings. In none of these limitations is there a limitation upon the period during which mortgages can be originated. It is clearly unacceptable for the Explanation to indicate a limitation where there is none.

SUBSTANTIVE CHANGES MADE BY BILL

Measure of Issuance Costs Limitation and of Safe Harbor Exception from Rebate Section 113(a)(13) of the Bill amends section 147(g) of the 1986 Code to apply the limitation on issuance costs against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 147(g) of the 1986 Code. Similarly, section 113(a)(16) of the Bill amends section 148(f)(4)(B)(iii)(I) of the 1986 Code to apply the measure of the cumulative cash flow deficit against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 148(f)(4)(B)(iii)(I) of the 1986 Code. Although not set forth in the 1986 Code, staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public. Such changes are substantive changes not appropriately made by a technical corrections act.

Many issuers sell their bonds at public sale after bidding. Under this arrangement, the issuer will cause the official statement to be prepared and printed, will cause notice of bids to be published two to three weeks prior to the bid opening, will receive bids and award the bonds to the winning bidder at the bid opening and will issue the bonds one to three weeks following the award of the bid. Under this procedure, the principal amount of the bonds must be determined prior to the time that the official statement is printed and the bids on the sale of the bonds are received, yet the amount of "proceeds" of the bonds is not known until after the winning bidder at the public sale resells the bonds to the public.

If, for example, an issuer determines that the principal amount of tax and revenue anticipation notes to be sold at public sale will be $10,000,000, based upon a projected safe harbor cumulative cash flow deficit of $9,000,000 and if, following public sale of the bonds, the winning bidder indicates that the notes were resold to the public at an original issue premium of one percent, the "proceeds" of the notes would be $10,100,000 and on the date of delivery of the notes, the issuer would know that if its projected cumulative cash flow deficit becomes the actual cash flow deficit, the "safe harbor" for rebate purposes will not be achieved because the projected deficit will not exceed 90 percent of the reoffering price of the notes. The modifications suggested by the Bill have a substantive effect upon issuer procedures for bond sale, may force the negotiated sale of bonds or the imposition of artificial restraints upon the reoffering price of the Notes. Such substantive provisions are improper points for inclusion in a technical corrections bill.

Application of Rebate Rules to Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds new clause (iv) to section 148(f)(4)(C) of the 1986 Code indicating that, unless certain stringent restriants are satisfied, the $5,000,000 small issuer exemption from rebate requirements does not apply to refunding bonds. Included among these restraints is a requirement that the refunded bonds must have satisfied the $5,000,000 exemption when issued. Thus, if the refunded bond either satisfied the rebate requirement or was exempt from the rebate requirement due to the expenditure exemption or for other statutory reason, the refunding bond would be automatically ineligible for the small issuer exemption. There is no indication in the Act that Congress did not intend for the small issuer exemption to apply to refunding bonds (as well as new money bonds) without limitation, and there is no clear reason for a distinction between bonds which refund prior bonds which complied with rebate requirements and bonds which refund prior bonds which were exempt from rebate requirements, and bonds which are issued for provision of construction funds, acquisition funds, or working capital funds. The distinction which Congress made in the Tax Reform Act of 1986 and which should be maintained without erosion by the Technical Corrections Act of 1987 is a distinction between issuers rather than a distinction between purposes of bond issuance. The exclusion of refunding bonds from the exemption. Proposed clause (iv) of section 148(f)(4)(C) is substantive in effect and highly inappropriate for a technical corrections bill. Proposed clause (iv) should be withdrawn.

Designation of Refunding Bonds. Section 109(b)(5) of the Bill provides reformulated rules to determine whether refunding bonds may qualify as qualified tax-exempt obligations ("QTEO's") for certain bank deductibility provisions and to indicate how refunding bonds are to be taken into account in determining whether other bonds qualify as QTEO's. This comment offers our understanding of the legislative language that the Bill would add to the 1986 Code as section 265(b)(3)(F) and (G) and offers our reasons for concluding that the Explanation fundamentally misrepresents the plain meaning of that language.

Section 265(b)(3)(F) provides a general rule that in determining the status of a non-refunding bonds, a refunding bond will not be taken into account for purposes of the $10 million limit of section 265(b)(3)(C) provided that (1) the refunding is not an advance refunding and (2) the amount of the refunding issue does not exceed the outstanding amount of the refunded issue. Thus an issuer may issue up to $10 million of construction (non-refunding) bonds in a year and designate them as QTEO's notwithstanding the fact that the issuer issues additional amounts of refunding bonds during the year, provided the refunding bonds meet the standards of section 265(b)(3)(F).

Section 265(b)(3)(G)(i) denies QTEO status to any bond that is part of an issue that includes any refunding bonds and exceeds $10,000,000 in aggregate face amount. This rule means that an issuer could not issue a multi-purpose issue of $15 million of which $7 million was refunding bonds and $8 million of construction bonds as QTEO's on the ground that section 265(b)(3)(F) made the $7 million of refunding bonds irrelevant.

Section 265(b)(3)(G)(ii) allows refunding issues that meet the test of section 265(b)(3)(G)(i) to achieve QTEO status through either a regular designation or a "deemed" designation. Under the regular designation route, the refunding issue must meet the general standards applicable to non-refunding issues, such as the limitation of section 265(b)(3)(A) that the total of the designated issue plus all other bonds issued (or anticipated to be issued) during the same calendar year cannot exceed $10,000,000. Under the deemed designation route, the issue must pass muster under a different set of standards: specifically, the prior bonds must themselves have been QTEO's, and the refunding must be a "non-advance" refunding which does not exceed the outstanding amount of the prior bonds and which complies with specified maturity limits. The deemed designation route does not, however, require the issue to take into account other bonds issued during the calendar year. Thus an issuer using the deemed designation provisions can preserve the QTEO status of a financing through one or more refundings even though there are other financings during the year of the refundings such that the refunding bonds could not qualify outside the deemed designation provisions.

The Explanation states that the deemed designation provisions are the only route by which a refunding issue can achieve QTEO status. In other words, the Explanation takes the position that a refunding issue cannot be a QTEO issue unless the prior issue "was designated, qualified for, and was taken into account under the $10 million limitation when issued." (Page 76.) This comment by the Explanation is not supported by the statutory language of the Bill, which as noted above permits refunding bonds to qualify either by actual designation or by deemed designation. Further, the rule proposed by the comment is not justified by any sensible policy. It is inappropriate to deny an issuer which issued bonds prior to the effective date of the 1986 legislation the opportunity to refund them with QTEO's, provided the refunding bonds meet the tests set forth for refunding bonds as described herein.

REQUIRED ADDITIONAL TECHNICAL CORRECTIONS

Inclusion of "On Behalf Of" Issuers in Small Issuer Rebate Exception. The small issuer exception from rebate requirements contained in section 148(f)(4)(C)(i) of the 1986 Code relates to governmental units with general taxing powers. Congressional staff has indicated that the exception applies to entities which issue on behalf of governmental units with general taxing powers. It is suggested that subclause (I) (as redesignated by section 113(a)(17)(A)(ii) of the Bill) of section 148(f)(4)(C)(i) of the 1986 Code be amended to read as follows (new language is indicated by underlining):

> (I) the issue is issued by or on behalf of a governmental unit with general taxing powers.

It is also noted that there appears no clear legislative purpose to limiting the small issuer exemption to governmental units with general taxing powers. The intent of the exception should be to limit its application to governmental bonds. We suggest, therefore, that consideration be given to the entire elimination of of subparagraph (I).

Change in Use Rules Applied to Transitioned Refundings of Residential Rental Bonds. Section 1313(a) of the Act permits current refundings of certain bonds, including residential rental bonds originally issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Subparagraph (E) of section 1313(a)(3) of the Act indicates that the change in use provisions contained in section 150(b) of the 1986 Code apply to such transitioned refunding bonds. Paragraph (2) of section 150(b) of the 1986 Code relates to change in use of facilities financed with bonds issued as tax-exempt under section 142(a)(7) of the 1986 Code and does not refer to facilities financed as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Since it was not the purpose of the transition rule for refundings of residential rental projects to impose the new low income restrictions applicable to bonds issued under section 142(a)(7) of the 1986 Code, subparagraph (E) of section 1313(a)(3) of the Act requires modification to indicate its inapplicability to bonds issued to refund prior bonds issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. It is suggested that section 1313(a)(3)(E) of the Act be amended by the Bill to read as follows (new language is indicated by underlining):

> (E) Except in the case of bonds issued for facilities qualifying under section 103(b)(4)(A) of the 1954 Code, the provisions of section 150(b) of the 1986 Code (relating to change in use).

Rebate as Applied to Tax and Revenue Anticipation Noes. Section 148(f)(4)(B)(iii) of the 1986 Code relates to an exemption from rebate for tax and revenue anticipation notes which satisfy a "safeharbor" in terms of cumulative cash flow deficits. Footnote 173 of the Blue Book indicates that it is expected that the Treasury Department will treat deficits as occuring only if no amounts other than bond proceeds are available to pay expenses for that which the proceeds are used. In determining available amounts, amounts in special purpose accounts or otherwise earmarked are available if the governmental unit either (1) established the restrictions on the use of the other funds or (2) has the power to alter the use of the other funds. Footnote 173 indicates a significant expansion of the definition of "available revenues" under existing Treasury regulations.

It is contended that Congress did not intend that present Treasury regulations of "available revenues" be modified when Congress enacted the safe harbor exception to rebate. The Bill should modify Section 148(f)(4)(B)(iii) to include a definition of "available revenues" which is based upon the definition of such term which is included in present Treasury regulations.

Security for Qualified Redevelopment Bonds. Subparagraph (B) of section 144(c)(2) of the 1986 Code relating to the security for qualified redevelopment bonds is unclear. It has been variously stated that existing clause (i) was designed to permit general obligation bonds, real property tax increment bonds, sales tax increment bonds and bonds combining one or more of such sources of security. It has also been indicated that no discrimination between sources of security was intended by the reference in existing clause (i) to "primarily secured by" as contrasted with the reference in clause (ii) to "reserved exclusively for". It has also been indicated that the reference to "reserve exclusively for" was not intended to eliminate state statutory requirements for use of tax increment for, for example, low or moderate income, or to eliminate past and future contracts and other arrangements whereby a portion of tax increment was provided to governmental units not engaged in redevelopment or renewal, for example, to school districts to be used for school purposes, as opposed to its use for bond debt service. The Blue Book indicates that payment of the bonds is not to be "derived from" payments such that the bonds would have been rendered as industrial development bonds under prior law, but there is no indication in the Act that this is true. A clarification which conformed to the Blue Book would be a substantive, rather than a technical change. It is suggested that subparagraph (B) of section 144(c)(2) of the 1986 Code be amended to read as follows:

> (B) the payment of the principal and interest on such issue is primarily secured by taxes of general applicability, or an increment thereof, imposed by a general purpose governmental unit.

Application of Maturity Limit to Qualified 501(c)(3) Bonds for Working Capital. Qualified 501(c)(3) bonds may be issued for the financing of purposes other than facilities. For example, qualified 501(c)(3) bonds may be issued for financing of working capital or refunding of prior debt. In such event the maturity limitation is inapplicable, by its terms. It is suggested that the original intent of Congress be clarified by amending section 147(h)(2) of the 1986 Code by adding a new sentence at the end thereat to read as follows:

> 'Subsection (b) shall apply to qualified 501(c)(3) bonds only with respect to facilities financed with such bonds.'

Application of Expenditure Exception to Rebate Requirement. Under present law, rebate requirements do not apply if gross proceeds of an issue are expended for the governmental purpose of the issue within 6 months of issuance. Most issues, however, provide for the funding of a reasonably required reserve fund in addition to funding for the primary governmental purpose of the issue. Reserve funds are retained to assure that a source of payment of the issue is available in the event of a temporary insufficiency of other sources of payment of debt service. It is suggested that the expenditure exception to the rebate requirement be amended to provide that a reserve fund need not be expended in order for the 6 months expenditure exception to apply.

It is also suggested that the expenditure exception be amended to to provide that the use of proceeds of an issue for redemption of the issue be treated as an expenditure for the governmental purpose of the issue on the date upon which such redemption is made.

In certain cases, the issuer may fully intend on the date of bond issuance to expend the proceeds of the bonds within six months thereof, but for reasons beyond the control of the issuer or for inadvertence, the issuer is unable to expend such proceeds. The suggested amendment would enable an issuer to cure the problem and thus to avoid rebate procedures by using the amounts which were not expended for redemption of the bonds. The Federal Government will thereby derive more revenue from the elimination of outstanding tax-exempt bonds than it would from the rebate of "excess" investment earnings.

Change in Use for Single Family Housing Bonds. Footnote 196 on page 1221 of the Blue Book indicates that, with respect to the change in use provisions contained in section 150(b)(1) of the 1986 Code for qualified mortgage bonds, Congress intended that the disallowance of interest deductions for bond-financed housing cease prospectively if the residence again qualifies as the mortgagor's principal residence. The footnote indicates, "A technical amendment may be necessary for the statute to reflect this intent." Such technical amendment should be made by the Bill.

Definition of "Proceeds". The term "proceeds" is used in a number of the provisions contained in sections 141 through 150 of the 1986 Code. Staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public, that is, an amount equal to the price at which a substantial amount of the bonds of each maturity were sold to the public. Generally, this amount is equal to the face amount of the bonds, plus accrued interest on the bonds, plus original issue premium, less original issue discount. The term should be defined in the Bill.

Retroactive Designation of Bonds as Qualified Bonds for Purposes of Bank Deductibility Provisions. Section 109(b)(3) of the Bill provides that issuers may retroactively designate their bonds as bank qualified under the $10 million exception if certain conditions are met. For bonds issued after August 7, 1986 and before January 1, 1987, the issuer has until January 1, 1988 to make the designation. However, for bonds issued between January 1, 1986 and August 7, 1986, an additional requirement is added that the issue must have made a designation at the time of issue that it intended to qualify under section 802(e)(3) of H.R. 3838.

There is no persuasive reason for this additional requirement for bonds issued on or before August 7, 1986. Many small issuers did not make designations during such time period simply because the House Bill was pending and not yet law. Other small issuers thought they were protected by the March 14, 1986 Joint Statement and essentially ignored H.R. 3838. These issuers are now being asked to designate their bonds as bank qualified by investment bankers.

It is suggested that all bonds issued in 1986 may be retroactively designated as bank qualified until January 1, 1988.

Section 1301

STATEMENT OF THE COLLEGE CONSTRUCTION LOAN INSURANCE ASSOCIATION

Re: Technical Corrections Act of 1987
Correction for College Construction Loan
Insurance Association ("CLIA")

Dear Mr. Leonard:

In October 1986, Congress authorized the creation of a for-profit, private corporation, the College Construction Loan Insurance Association ("CLIA"), to provide financial guarantee insurance, reinsurance and letter of credit support to issuers of educational facilities obligations. In doing so, Congress was responding to an estimated $30-$50 billion deficiency in the nation's educational infrastructure by authorizing the creation of an entity whose function would be to provide issuers (primarily non-profit institutions) with a mechanism (insurance) to access the capital markets.

The timing of CLIA's creation in October 1986 post-dated the enactment of the Tax Reform Act. Thus, no provision was made in recodified Section 149(b) of the Code to indicate that CLIA's guarantees are not federal guarantees.

As a result, the status of CLIA's guarantees remains in limbo and CLIA is unable to secure bond counsel's opinion that its guarantee of tax-exempt bonds would not destroy the tax-exempt status of the bonds. As explained below we believe that Congress should exempt CLIA's guarantees under recodified 149(b) and that it should be properly corrected through the Technical Corrections Act of 1987.

I. The Problem

The Tax Reform Act of 1986 denies tax exemption for interest paid on bonds if the payment of the interest is directly or indirectly guaranteed by the federal government or by an instrumentality of the federal government. This provision was originally enacted in the Deficit Reduction Act of 1984 primarily to prevent the proceeds of tax-exempt bonds from being deposited in a federally-insured institution (such as a bank) to guarantee the payment of interest and principal on the bonds. This technique provides a "double" government subsidy to bond purchasers, namely, tax-exempt income and a federally-guaranteed payment of interest and principal. The Tax Reform Act of 1986 correctly denies tax exemption in these cases. As discussed below, however, new Code section 149(b) is drafted in a manner which would have an unintended negative impact on an unrelated financing area.

Legislation authorizing the creation of a private, for-profit corporation, the College Construction Loan Insurance Association ("CLIA"), came about as a result of the Higher Education Amendments of 1986, Pub. L. No. 99-498, 100 Stat, 1268 (codified and amended as 20 U.S.C. §1132f et seq. (1986). CLIA was authorized for the purpose of providing financial guarantee insurance, reinsurance and letter of credit support to obligations issued to finance or refinance the acquisition or construction of educational facilities. CLIA has been incorporated as a private corporation in the District of Columbia. While the

Secretary of Education is authorized under the CLIA statute to purchase up to $20,000,000 of CLIA Voting Common Stock in each of the five fiscal years following CLIA's incorporation, the United States has no liability for CLIA's obligations. Further, it is contemplated that the majority of CLIA's common stock will be privately owned. Section 1132f of 20 U.S.C. explicitly provides that CLIA is not an agency or instrumentality of the United States, and section 1132f-6 expressly provides that no obligation which is insured, guaranteed, or otherwise backed by CLIA shall be backed by the full faith and credit of the United States.

In short, CLIA's statute makes it clear the CLIA should not be a "government instrumentality" whose guarantees would deny tax-exempt status to obligations. CLIA has none of the indicia of government status commonly associated with other government instrumentalities. CLIA cannot sell its obligations to or otherwise borrow from the Federal Financing Bank. Under CLIA's legislation, CLIA has no statutory authority to borrow with the Secretary of Education's guarantee and no authority to require that the Secretary of the Treasury purchase CLIA's debt obligations.

The determination of the tax status of CLIA's guarantees was specifically left to the jurisdiction of the Ways & Means Committee as is indicated in the last sentence of Section 757 of the Act: "[t]his Section shall not affect the determination of whether such obligation is guaranteed for purposes of Federal income taxes." It was intended that the tax status of CLIA guaranteed debt should be addressed not in the CLIA statute, but more properly in the Tax Reform Act. Unfortunately, however, the Tax Reform Act was enacted prior to the time the final CLIA legislation was passed by Congress and no exemption was included in the Tax Reform Act to cover CLIA guaranteed debt. What is essentially the result of a timing problem has prevented bond counsel from opining that CLIA's guarantees are not subject to Section 149(b) of the Internal Revenue Code. And, without such an opinion from bond counsel, CLIA cannot insure tax-exempt obligations.

II. Solution

We believe that the only solution to the CLIA problem is to correct Section 149(b) of the Code to include the exemption for CLIA which we believe would have been included had CLIA been extant at the time the Tax Reform Act was enacted. Therefore,we respectfully request that IRC section 149(b)(3)(A)(i) should be amended to read:

> "(i) any guarantee by the Federal Housing Administration, the Veteran's Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, or the College Construction Loan Insurance Association"

III. Reasons in Support of Technical Correction

The language in the Tax Reform Act of 1986 should be corrected to exempt CLIA's guarantees from the definition of federal guarantees under Section 149(b) of the Code for the following reasons:

1. CLIA's guarantees arenot and were never intended to be "federal" guarantees within the meaning of the Code and the lack of a specific exemption for CLIA guarantees is the result of a timing problem and not the result of any substantive disagreement over the status of CLIA's guarantees.

2. Current law provides clear exemptions for the guarantees of entities much more closely tied to the federal government than CLIA such as FNMA, FHLMC, GNMA and SLMA. Further, these other entities have been formed for purposes other than to provide insurance services, which is not the case with CLIA. As such, the lack of a clear exemption for CLIA guarantees under the Code adversely affects CLIA's basic and only business.

3. The activities of CLIA in connection with tax-exempt financing are consistent with the purposes outlined by the Congress in the legislation which established CLIA and do not conflict with the policy and intent of new Code Section 149(b). Failure to correct what is essentially a legislative oversight will render CLIA unable to insure tax-exempt obligations and thus incapable of fulfilling its legislative mission.

In summary, the CLIA statute makes CLIA's private status very clear, CLIA's activities do not conflict with the general intent of Code Section 149(b), and CLIA should be specifically excluded from Section 149(b) and thus render CLIA able to fulfill its legislative mission. For reasons stated, CLIA should be specifically exempt from the federal guarantee provisions of Code section 149(b).

We would appreciate your addressing this issue. If you have any questions concerning our description of the problem or proposed solution, I encourage you to contact William T. Brack at 659-0702.

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July 1, 1987

Robert Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Comments on the Technical Corrections Act of 1987 (HR 2636 and S 1350); Tax-Exempt Bonds and Intergovernmental Cooperation

Dear Mr. Leonard:

Please accept and appropriately file and present this as my formal written comments in connection with the Technical Corrections Act of 1987 (HR 2636 and S 1350, collectively, the "Bill"). The Bill provides technical corrections to the Tax Reform Act of 1986 (the "Act"), which enacted the Internal Revenue Code of 1986 (the "Code").

TAX-EXEMPT BONDS AND INTERGOVERNMENTAL COOPERATION

These comments will concern selected provisions of the Act and the Code as they affect tax exempt bonds and local intergovernmental cooperation. The essential problem is that the Act and the Code seem to assume that all issuers of tax exempt bonds are a single governmental entity. Although this appears to be an inadvertency, certain tax exempt bond provisions of the Act and the Code frustrate and discourage local intergovernmental cooperation. The selected provisions which these comments will address, concerning adverse intergovernmental cooperation consequences, are as follows:

1. The $5,000,000 so-called "small issuer" exception of Section 148(f)(4)(C) of the Code related to arbitrage rebate.
2. The $10,000,000 "qualified tax-exempt obligation" exception to financial institution non-deductibility of Section 265(b)(3) of the Code.
3. The "available" revenues feature of footnote 173 of the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 (the "Blue Book") concerning Section 148(f)(4)(B)(iii)(II) of the Code.

SECTION 148(f)(4)(C) SMALL ISSUER EXCEPTION

Section 148 of the Code basically provides, with certain exceptions, that to the extent investment yield on bond proceeds exceeds the yield on the bonds the excess is to be rebated to the federal Treasury. Among the ways to avoid the rebate requirement, bond proceeds can be spent in 6 months or the investment of bond proceeds can be in tax-exempts. Up to $100,000 of debt service fund earnings are excepted from rebate. Of the exceptions, the $5,000,000 so-called "small issuer" exception is perhaps the most critical. That exception is expressed in Section 148(f)(4)(C) as follows:

> (C) EXCEPTION FOR SMALL GOVERNMENTAL UNITS. -- An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if--
>
> (i) the issue is issued by a governmental unit with general taxing powers,
>
> (ii) no bond which is part of such issue is a private activity bond,
>
> (iii) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and
>
> (iv) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit (and all subordinate entities thereof) during the calendar year in which such issue is issued is not reasonably expected to exceed $5,000,000.

The intergovernmental cooperation concern relates to paragraph (i)--"the issue is issued by a governmental unit with general taxing powers." Let's look at an example where two cities and a county form an intergovernmental contractual association (the "Association") to develop a landfill located in the county's unincorporated area for the disposal of solid waste.

The Association is not a governmental unit. It is an intergovernmental contractual association. It does not have taxing power. Let's assume that otherwise it complies with Section 148(f)(4)(C). This will not be an unusual situation, at least under the constitution and laws of the State of Illinois where there is very broad authority to engage in intergovernmental cooperation. Let's also assume that the landfill is an Association owned and operated facility. There is no "private activity" feature involved.

Because of the requirement of Section 148(f)(4)(C)(i) of the Code that the Association be a "governmental unit with general taxing powers" the Association's bonds to finance the landfill or its operations are not literally subject to the $5,000,000 small issuer exception. It is not a governmental unit, and it does not have taxing power. Let's also assume that the Association plans a $675,000 issue to fund its operations for a year and to pay preliminary engineering and hydrogeology costs related to the preliminarily selected landfill site. Let's also assume that the two cities and the county provide part time personnel services to the Association to assist its start up. This Association is literally subject to the arbitrage rebate requirements for its $675,000 "seed money" issue.

To dramatize what this means, Infrastructure News (May 1987, CD Publications, Silver Spring, MD) reported that the Treasurer of the State of Maine said that with respect to a $1,151.59 rebate on a note issue the cost to the State of Maine was $100,000 for the investment, computation, bidding and return requirements concerning arbitrage rebate under Section 148(f) of the Code. Assuming that $100,000 might be an exaggeration, we all know from our experiences with Section 103(c)(6) of the Internal Revenue Code of 1954, as amended, and the related Treasury Regulations §1.103-15AT that many multiples of $1,151.59 would not be surprising in that case. Even proving there is no rebatable amount will likely be expensive. It is critical for a small issuer to be able to use an exception.

The Association's landfill is clearly a governmental function. A landfill is a necessary, if not critical, requirement in any solid waste disposal approach. Recycling, energy conversion and other approaches always leave some residual amount for landfill disposition. The Association is marginally staffed. The amount of $675,000 is hardly a large issue. This is 1 to 2 years of operating funds while site selection proceeds. Under Section 148(f) of the Code the Association should invest, rebate, compute yields and otherwise comply with certain technical tax rituals even to prove it should rebate nothing.

This could be avoided. For example, the two cities and the county could each issue $225,000 and make it available to the Association. This would mean three sets of issuance costs. This is senseless and seemingly an unintended result of the Code. However, as written the Code appears to require it. Section 148(f)(4)(C)(i) needs technical correction, or at least clarification, in order to allow this and similar small issues for clearly governmental purposes to proceed without the threat and cost of arbitrage rebate.

The Association is made up of three local governmental units which each have general taxing powers. The Association is not a Section 501(c)(3) entity. The Association is an intergovernmental contractual association of three local governmental units. The Association issues bonds "on behalf of" those three local governmental units. However, where those three local governmental units under plainly available intergovernmental cooperation authority of the State's constitution and laws jointly created the Association to undertake and exercise a clearly governmental function, Section 148(f)(4)(C)(i) of the Code should be corrected, or sufficiently explained, to allow this sort of "on behalf of" intergovernmental cooperation effort to avail itself of the $5,000,000 small issuer exception to Section 148(f) rebate.

The federal government should not discourage and frustrate local intergovernmental cooperation by an unforeseen and unintended result of the "general taxing powers" provision of paragraph (i) of Section 148(f)(4)(C). This and an appropriate allocation of an intergovernmental issue to the superior entities can be very easily done by a corrective provision or explanatory statement to the effect, as follows: An intergovernmental entity created by governmental units having general taxing powers shall be deemed to comply with Section 148(f)(4)(C)(i) and each such governmental unit shall be allocated its proportionate share of the intergovernmental issue.

There is another problem with the $5,000,000 small issuer exception in Section 148(f)(4)(C). It does not anticipate that the issuing entity could be multijurisdictional, such as in the case of the Association. Where the issuing entity is multijurisdictional, how would the issue amount be allocated to those local governments that created and established the Association? Is it 1/3 to each, or some other fraction (e.g., population ratios) based upon the intergovernmental agreement creating and establishing the Association? Is each to be allocated 100% so the effect is to essentially multiply the impact of the Association's issue? What if 10 or 20 local governments (a real possibility in Cook County, Illinois) intergovernmentally cooperate? Does this mean that the issue's impact is allocated and multiplied 10 or 20 times? Certain authors of the Blue Book and Treasury staff have divided in their public and private reactions to this. Some say it is allocated 100%; some say it is divided; and all say they haven't thought about it before, don't know and aren't sure. Obviously, multiplying the issue by allocating 100% to each superior entity will have a discouraging and frustrating impact on intergovernmental cooperation. It does not seem that this is an intended or required result of the Code. However, staff members are divided and confused in their reactions to this and how it is to be treated. Therefore, technical correction and clarification to require an allocation is appropriate.

Of course, there is a way to avoid this at the local level. Each city and the county could issue its own bonds and make the proceeds available to the Association. This senselessly expensive and time consuming technique of multiplying issuance costs does not seem to be intended by tax reform to be the way to use the $5,000,000 small issuer exception in Section 148(f)(4)(C) in an intergovernmental context. If the exception can be utilized in that way, why not clearly allow the single intergovernmental cooperation issue in the first instance. Tax reform surely did not intend to discourage and frustrate intergovernmental cooperation. Nowhere in the Code is local intergovernmental cooperation recognized in this context. This unanticipated and unintended result is proper for technical correction, or at least clarification in the legislative record. The way Section 148(f)(4)(C)(i) is written it would seem most unlikely that regulations (which will be too late and, in the usual case, likely narrowly written) could or will provide relief.

Section 113(a)(17)(A) of the Bill in the context of intergovernmental cooperation, in much the same manner described above concerning Section 265(b)(3) of the Code, almost mandates a multiplication of the impact of an issue similar to that planned by the Association. This adds more confusion in the context of local intergovernmental cooperation and deserves clarification and appropriate correction.

SECTION 265(b)(3) SMALL ISSUER EXCEPTION

Section 265(b)(1) of the Code basically provides, subject to certain exceptions, that banks, savings and loan associations and other financial institutions may not deduct any of their interest costs of purchasing and carrying obligations acquired after August 7, 1986, the interest on which is excluded from gross income under Section 103 of the Code. Section 265(b)(1) provides that in the case of such financial institutions "no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest" for bonds acquired after August 7, 1986. Prior to the 1986 Code such financial institutions could deduct 80% of such interest expenses.

There is a so-called $10,000,000 "small issuer" exception from the general rule of nondeductibility. It is available only for certain governmental and qualified 501(c)(3) bonds. That small issuer exception applies only to "qualified tax-exempt obligations". Section 265(b)(3) of the Code provides:

> (3) EXCEPTION FOR CERTAIN TAX-EXEMPT OBLIGATIONS.--
>
> (A) IN GENERAL.--Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section 291(e)(1)(B) as if it were acquired on August 7, 1986.
>
> (B) QUALIFIED TAX-EXEMPT OBLIGATION.--For purposes of subparagraph (A), the term 'qualified tax-exempt obligation' means a tax-exempt obligation which--
>
> (i) is not a private activity bond (as defined in section 141), and
> (ii) is designated by the issuer for purposes of this paragraph,
>
> For purposes of the preceding sentence and subparagraph (C), a qualified 501(c)(3) bond (as defined in section 145) shall not be treated as a private activity bond.
>
> (C) LIMITATION ON ISSUER.--An obligation issued by an issuer during any calendar year shall not be treated as a qualified tax-exempt obligation unless the reasonably anticipated amount of qualified tax-exempt obligations (other than private activity bonds) which will be issued by such issuer during such calendar year does not exceed $10,000,000.
>
> (D) OVERALL $10,000,000 LIMITATION.--Not more than $10,000,000 of obligations issued by an issuer during any calendar year may be designated by such issuer for purposes of this paragraph.
>
> (E) AGGREGATION OF ISSUERS.--For purposes of subparagraphs (C) and (D), an issuer and all subordinate entities thereof shall be treated as 1 issuer.

With respect to the Association's plans for 1987, the $675,000 issue does not present any problems. The Association does not contemplate the issuance of bonds in 1987 such that it could fail to qualify for the $10,000,000 small issuer exception. However, if plans proceed according to schedule, in 1988 the

Association reasonably anticipates issuing up to $9 million of bonds to finance the acquisition and construction of a landfill, access roads and related and appurtenant fixtures and equipment. Other financings and increased costs may result in exceeding the $10,000,000 limit for the small issuer exception. In any event, the $10,000,000 limit clearly will resolve one way or the other. As will be shown, the problem likely will be with respect to the two cities and the county.

If the Association exceeds $10,000,000, it clearly cannot utilize the small issuer exception. In this example of an intergovernmental undertaking, the problem is with the aggregation rules in subparagraph (E). That is, how does the $9+ million become allocated to the two cities and the county that constitute the Association? Will they each be attributed $9+ million such that their individual financing plans are compromised as to "bank qualification" by being members of the Association? In computing the $10,000,000, Section 265(b)(3)(E) requires that "an issuer and all subordinate entities thereof shall be treated as 1 issuer". The Association is issuing the bonds "on behalf of" the two cities and the county. The situation, is essentially the same as described above at page--concerning the multiplication of the issue amount under Section 148(f)(C)(4) of the Code. Section 109(b)(5) of the Bill almost reads as though it mandates multiplication of the issue amount for the Association. Instead of clarification another confusing concept is added, particularly as to the impact on intergovernmental cooperation.

There are several approaches to analyze this in the intergovernmental context of the Association. The Association as an issuer has no "subordinate" entity, and, therefore, neither of the cities nor the county are charged with any allocation of the Association's bonds. In fact, the Association is rather the "subordinate" entity of the two cities and the county. We are told by committee and Treasury staff, however, which is the case also above described concerning the $5,000,000 small issuer exception under Section 148(f)(c)(4), the "subordinate" concept actually runs both directions. That is, the superior entity also is charged in computing the exception. Section 109(b)(5) of the Bill would seem to require this as a result in an intergovernmental context. The implications of this analysis for the Association's 1988 plans for a $9+ million issue also affect the $5,000,000 exception under Section 148(f)(4)(C) for the two cities and the county. It is important that the two cities and the county preserve "bank qualification" for their issues by only being allocated a part of the $9+ million Association issue in 1988.

Another approach is to allocate 100% to each of the cities and to the county or to allocate on the basis of 1/3 each (or otherwise as the intergovernmental agreement may allocate costs and benefits--for example, by population ratios). Again, as was the case for the above Section 148(f)(4)(C) analysis, committee and Treasury staff divide among themselves as to the approach. Section 109(b)(5) of the Bill may have created a local intergovernmental problem that did not previously exist. However, as also was the case regarding Section 148(f)(4)(C), the committee and Treasury staff who have commented are unanimous that no one ever considered the local intergovernmental cooperation impacts of the tax exempt bond provisions of the 1986 Code or of the Bill, and particularly as to the allocations of an intergovernmental issue to the contracting local governmental units.

As noted above related to the similar Section 148(f)(4)(C) problem, it is difficult to believe concerning a matter no one even considered that Congress intended to frustrate and discourage local intergovernmental cooperation and activities. This is particularly so concerning clearly governmental activities. The Association's landfill is anticipated to be governmentally owned and operated. There are to be no private activity features.

Since never addressed or considered, the above deserve technical correction and clarification to permit the use of the exceptions with the least impact on the intergovernmentally cooperating units of local government.

INTERGOVERNMENTAL SOPHISTICATION

Staff members of tax writing committee when presented with the above problems and concerns have replied that a major consideration in the small issuer exceptions was to allow concessions to less sophisticated issuers. This is more so with respect to the terrible complexities of arbitrage rebate than financial institution deductibility. Staff reply continues to the effect that the Association as an intergovernmental entity must have a sophistication that justifies unavailability of the exceptions. That is, the economies of scale and size of the Association contradict the use of a rule intended to be available to less sophisticated issuers. They say this is more so under Section 148(f)(4)(C) than Section 265(b)(3).

However, this illustrates a misunderstanding of local intergovernmental cooperation and how entities such as the Association are created, established and at least initially operate. The activities of the Association are not a going concern. Presently the Association has no facilities or staff. This is a new intergovernmental undertaking. The public works, engineering, planning and legal staffs of the two cities and the county, which constitute the Association, are taking this on as an additional duty and function. Much of the professional work is part time and on weekends and evenings. Already these professionals have a full week. In summary, at least for now, the Association is likely less capable or sophisticated than any one of the entities that make it up. This is not unusual for the start up of an intergovernmental undertaking.

Illinois has over 6,500 units of local government. There are approximately 102 counties, 1150 municipalities, 1500 townships, 2000 school districts and over 2000 other special purpose districts, authorities, boards and commissions. Intergovernmental cooperation, activities and undertakings are relatively common. Joint undertakings, such as illustrated by the Association, are encouraged by a great number of provisions in Illinois law. Of particular note are two general provisions: Section 10 (Intergovernmental Cooperation) of Article VII of the Constitution of Illinois and Section 741 et seq. of Chapter 127 of the Illinois Revised Statutes (Intergovernmental Cooperation Act).

The Association is one of a number of joint intergovernmental contractual associations. Such associations of governmental units should be treated as qualifying under Section 148(f)(4)(C)(i) as long as all member entities have general taxing power. The divided allocation (not 100% attribution to each governmental member of the Association) under Sections 147(f)(4)(C) and 265(b)(3)(E) should apply. These points deserve technical correction and clarification. [Although Illinois is described above, as chairman of the National Institute of Municipal Law Officers' Committee on Intergovernmental Cooperation, I suggest to you that this is not unique to Illinois and is of national concern.]

Blue Book-Footnote 173

Returning to arbitrage rebate, Section 148(f)(4)(B)(iii)(II) of the Code concerns tax and revenue anticipation notes and bonds (TRANS). The concern with TRANS is that an issuer will issue bonds for operating revenues when there is no real need for the funds (that is, no "cash flow deficit" exists or is reasonably imminent) and derive an arbitrage profit. This process could be repeated in each fiscal period. Section 148(f)(4)(B)(iii)(II) addresses this by providing that "the term cumulative cash flow deficit means, as of the date of computation, the excess of the expenses paid during the [applicable] period...which would ordinarily be paid out of or financed by anticipated tax or other revenues over the aggregate amount available (other than from the proceeds of the issue) during such period for the payment of such expenses." A major problem is describing what amounts are "available". Footnote 173 of the Blue Book addresses this problem in a far reaching way:

> "173/ Congress intended that, for purposes of the rebate requirement, the Treasury Department will adopt rules that provide that deficits are treated as occurring only if no amounts other than bond proceeds are available to the governmental units to pay the expenses for which bond proceeds are to be used. In determining whether an amount is available to a governmental unit, these rules may provide that the fact that the amount is deposited in special purpose accounts or otherwise earmarked is to be disregarded if the governmental unit using the TRAN proceeds either (i) established the restrictions on the use of the other funds, or (ii) has the power to alter the use of the other fund. But see, Treas. reg. sec. 1.103-14(c)(3)."

IRS Notice 87-42 essentially forestalls the application of the more far reaching implications of footnote 173 until its impact and broad definitional reach can be reassessed. However, it is not unreasonable to consider that the definitional problem of "available" could or might be addressed in the debate surrounding the technical corrections Bill.

There are local intergovernmental cooperation implications. The Association again provides an example. It is set up solely as a revenue supported entity on an enterprise fund basis. That is, it is self-supporting based upon its fees and charges, much as many water and sewer systems. The $675,000 issue the Association plans is largely for operating until a revenue generating facility is on line. Thus the planned issue essentially constitutes a TRAN under the 1986 Code.

In the context of the Association, let's assume that as to the two cities, City A has substantial contingency funds and City B has none and that the county is operationally running with expenses exceeding revenues. Within the meaning of footnote 173's treatment of "available", several concerns arise. One, the Association conceivably could borrow from City A. Two, City A participated in the intergovernmental agreement establishing the Association and arguably established the restrictions contained in that agreement related to funding. Three, the two cities and the county have the power to alter the intergovernmental agreement related to funding. In this context, what funds, if any, are "available" within an approach similar to footnote 173? Are there "no amounts other than bond proceeds... available"? Footnote 173 is extraordinarily broad in its literal reach.

As to intergovernmental cooperation in the context described above technical correction and clarification are necessary. Such technical correction and clarification should be to the effect that "available" in Section 148(f)(4)(B)(iii)(II) [and any treatment similar to or succeeding footnote 173] means that all participants must have funds so "available". If any one which has an ownership interest [mere purchase of services by intergovernmental agreement should not qualify] on the same basis as the others [to include a financially weak participant other than on an ownership basis the same as the others would be an abuse as well as an artifice and/or device] does not have funds so "available", a TRAN shall be tested for qualification as to cumulative cash flow deficit on the basis of the least capable. Any other rule would discourage and frustrate local intergovernmental cooperation efforts and activities.

CONCLUSION

Based upon the comments and reactions of House Committee on Ways and Means, Senate Committee on Finance and Treasury staff, no thought was given to the local intergovernmental impacts of the 1986 Code's tax exempt bond provisions. Opportunities for local intergovernmental cooperation are many and are encouraged by the constitutions and laws of most states. Identified above are three selected areas of major concern: (1) Section 148 (f)(4)(C) arbitrage rebate small issuer exception; (2) Section 265(b)(3) small issuer exception covering financial institution deductibility (so-called "bank qualification"); and (3) Section 148(f)(4)(B)(iii)(II) [Blue Book footnote 173] concerning "available" funds and TRANS.

An example involving solid waste disposal and the Association established by two cities and a county was used to illustrate the problems and concerns for which technical correction and clarification efforts are requested. The example in all material respects is not hypothetical. It is provided because it is real and present. The City of Champaign, Illinois, the City of Urbana, Illinois, and the County of Champaign, Illinois, have created and established the Intergovernmental Solid Waste Disposal Association as an intergovernmental contractual association. It is not a unit of local government, and it does not have taxing power. The above substantially describes a planned financing and the impact of tax reform on the Association, the two cities and the county. We are aware of other Illinois projects which may be similar.

Immediate guidance is required in this area that Congress never considered. The regulation process will be too late, and it is difficult to envision other than an unyielding regulation or private ruling approach in an area that Congress has not addressed in the legislative process.

Please don't hesitate to contact me if you need anything further or have any comments or questions. Your collect calls to me, if any, will be accepted, and I would be happy to meet further with you concerning these matters. Six copies of these comments are herewith concurrently delivered.

Very truly yours,

Kurt P. Froehlich
KURT P. FROEHLICH

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July 15, 1987

BY FEDERAL EXPRESS

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Technical Corrections Act of 1987

Dear Mr. Leonard:

In the course of our representation as bond counsel of a territory of the United States, it has come to our attention that an omission from the Tax Reform Act of 1986 appears to have occurred concerning the ability of Territories of the United States to issue tax-exempt bonds. We have enclosed a copy of a memo further discussing this issue.

We would appreciate you directing the attention of the Staff of the Ways and Means Committee to the inclusion in the Technical Corrections Act of 1987 of a provision correcting this apparently unintended omission. Please call me if you have any questions or comments concerning this item.

Very truly yours,

Sam B. Karnes

Sam B. Karnes

SBK:ra-m

SBK7/07
PAG0103

MEMORANDUM

TO: Tom Leonard

FROM: Sam B. Karnes

DATE: July 9, 1987

RE: Omission of Territories of the United States from the Definition of Governmental Issuers of Tax-Exempt Bonds Under the Tax Reform Act of 1986

BACKGROUND

Section 103(a) of Internal Revenue Code of 1986 (the "1986 Code") provides, generally, that except as otherwise provided, gross income does not include interest on any State or local bond. In defining the terms "State or local bond" and "State", Section 103(c) of the 1986 Code includes obligations of a State, the District of Columbia and any possession of the United States, and political subdivisions thereof, but does not specifically include Territories of the United States as did Section 103(a)(1) of the Internal Revenue Code of 1954, as amended (the "1954 Code").

STATEMENT OF ISSUE

Did Congress intend to exclude obligations of Territories of the United States from the tax-exemption provided by Section 103(a) of the 1986 Code?

ANSWER

It appears from legislative history of the Tax Reform Act of 1986 (the "1986 Act"), that Congress did not intend to exclude interest on obligations of Territories of the United States from the tax-exemption of Section 103(a) of the 1986 Code.

PROPOSAL

The apparently inadvertent omission of Territories of the United States from the tax-exempt financing provisions of the 1986 Act could be ameliorated by the inclusion of Territories of the United States in Section 103(c)(2), which defines "State", and in Section 146(d), which presently addresses the calculation of private activity bond volume caps for States and possessions of the United States.

DISCUSSION AND AUTHORITY

Section 103(a)(1) of the 1954 Code provided that gross income did not include income on the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia. Additionally, Treasury Regulation Section 1.03-1(a) defines "State or local governmental unit", interest on obligations of which are generally not includable in gross income, to include a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

Section 103(a) of the 1986 Code provides that, subject to certain exceptions, gross income does not include interest on any State or local bond. Section 103(c)(1) of the 1986 Code states that "State or local bond" means an obligation of a State or political subdivision thereof. Section 103(c)(2) of the 1986 Code defines "State" to include the District of Columbia and any possession of the United States.

I was unable to locate anything in the legislative history of the 1986 Act indicating that Congress intended to exclude interest on obligations of Territories of the United States from the tax exemption granted to obligations of States and possessions of the United States. The word "Territory" was omitted by the House Ways and Means Committee from H.R. 3838, which reorganized and amended Section 103, and from its Report on H.R. 3838, without explanation of the reason for such omission. The reorganization of Section 103 contained in the House bill was approved by the Conference Committee, and the omission of "Territory" carried over into the 1986 Act without written evidence of a conscious desire by Congress to exclude obligations of Territories from tax exemption.

Although the 1986 Act and the General Explanation of the Tax Reform Act of 1986 Prepared by the Staff of the Joint Committee on Taxation and released May 7, 1987 (the "General Explanation") do not specifically include Territories of the United States within the list of qualified governmental units which may issue tax-exempt bonds under Section 103, the first sentence of the General Explanation discussing the provisions of the 1986 Act pertaining to tax-exempt bonds, found at page 1128 of the General Explanation, states, "Interest on obligations of States, Territories, and possessions of the United States and the District of Columbia, generally is exempt from Federal income tax under both prior and present law (Code Sec. 103)." (emphasis added). With the exception of the emphasized language, the above-quoted sentence from the General Explanation is identical to the opening sentence of the earlier House Ways and Means Committee Report on H.R. 3838, thereby possibly indicating that the omission of Territories was not intended and was not discovered until after the passage of the 1986 Act.

For the reasons stated above, it does not appear that Congress intended interest on obligations of Territories of the United States be taxed differently than interest on obligations of States, the District of Columbia, and possessions of the United States, although the 1986 Act does not presently list Territories of the United States under Section 103.

Village of Woodridge
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August 13, 1987

The Honorable Dan Rostenkowski
U. S. House of Representatives
2111 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing to ask your support for state and local governments' ability to issue tax and revenue anticipation notes (TRAN's), which are being threatened by an interpretation of the 1986 Tax Reform Act ("Act") by the staff of the Joint Committee on Taxation in Footnote 173 of the "Blue Book". Congress specifically created an exception to the rebate requirements in the Act for TRAN's financing, and never discussed nor considered redefining the calculation of a cash flow deficit, the basis for issuing TRAN's. It therefore appears that there is no basis for Footnote 173, which would include restricted funds in the calculation of the cash flow deficit, thus greatly reducing the amount of individual TRAN's, and hampering cash flow management by state and local governments.

On June 2, in response to complaints from representatives of state and local governments and the U. S. Congress, the Treasury Department issued a notice that temporarily permits issuers to disregard any implications of Footnote 173 and states that any future regulations issued by Treasury will be prospective only.

This is, however, only a temporary reprieve from Footnote 173. The Treasury Department is soliciting comments relating to the treatment of various government funds including capital projects, debt service, special revenue, enterprise and other funds for purposes of computing the cumulative cash flow deficit and the allowable size of TRAN's.

Please let Treasury Secretary Baker know of your objections to Footnote 173 so that Footnote 173 will not be implemented and thousands of state and local governments will be able to meet their cash flow needs.

Sincerely yours,

Kathleen A. Gregory

KATHLEEN A. GREGORY,
Director of Finance

KAG:ph

Section 1312

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Statement on the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)

This statement describes a technical problem arising out of the generic transition rules of the Tax Reform Act of 1986 (the "Act") that would prevent the tax-exempt financing of certain pollution control facilities consisting of a cooling tower and related facilities at the Wm. H. Zimmer Generating Station (the "Zimmer Facilities"). The Zimmer Facilities are owned as tenants in common by The Cincinnati Gas & Electric Company, Columbus and Southern Ohio Electric Company and The Dayton Power and Light Company (the "Companies"), and the financeable cost is not currently expected to exceed $120 million. Squire, Sanders & Dempsey has been retained by the Companies, and this statement is being submitted on their behalf.

The problem involves the imposition of a pre-September 26, 1985 "inducement resolution or other comparable preliminary approval" requirement by Section 1312(a)(1)(B) of the Act to the tax-exempt financing of a facility that commenced construction before September 2, 1972 and that will be completed on or after September 26, 1985. This matter is not addressed in the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) as originally introduced. The following review of the existing Treasury Regulations containing the official action or inducement resolution requirement and the history of Section 1312 of the Act, as they affect the Zimmer Facilities, indicates why this correction is appropriate. Because the facts giving rise to this problem are rather unique, it is believed that there are no other similarly affected facilities. Therefore, the suggested correction would have a very limited impact.

Under Treas. Reg. §1.103-8(a)(5)(ii), copy attached, an exempt facility which commenced construction, reconstruction or acquisition before September 2, 1972, could satisfy certain applicable timing requirements if an appropriate official action or inducement resolution was adopted before the facility was placed in service. Under this rule, a facility where construction was commenced before September 2, 1972 and was completed on or after September 26, 1985 could satisfy Treas. Reg. §1.103-8(a)(5)(ii) if an appropriate official action or inducement resolution was adopted on or after September 26, 1985 but before the facility was placed in service.

On September 26, 1985 the Joint Committee on Taxation released a summary of tax reform options which included provisions to change certain rules applicable to tax-exempt financing of certain exempt facilities such as the Zimmer Facilities. These provisions had an effective date of December 31, 1985 with a transition rule exception allowing tax-exempt financing after that date for certain of these facilities where construction was commenced before September 26, 1985 and was completed on or after that date. The proposed transition rule contained an additional requirement that "[f]acilities would be defined as property for which bond financing was approved by a governmental unit . . . before September 26, 1985." H.R. 3838 as passed by the House of Representatives in December 1985 contained a transition rule exception (including a pre-September 26, 1985 inducement resolution requirement) similar to that set forth in the earlier Joint Committee statement. H.R. 3838 as passed by the Senate in June 1986 contained a parallel transition rule exception but substituted "March 1, 1986" for "September 26, 1985." The Conference Committee version of H.R. 3838 adopted the House transition rule on this point so that Section 1312(a)(1)(B) of the Act, as enacted into law in October 1986, contained a pre-September 26, 1985 inducement requirement. Significantly, there is no indication in the legislative history of the Act that Congress intended to repeal Treas. Reg. §1.103-8(a)(5)(ii) with the enactment of Section 1312(a)(1)(B) of the Act.

The construction of the Zimmer Facilities began before September 2, 1972 and they have not yet been placed in service. Thus, under the existing Treasury Regulations, the Zimmer Facilities could meet the timing requirements for tax-exempt financing as long as an "inducement resolution" was obtained before the placement in service date. On the other hand, the generic transition rule of Section 1312(a)(1)(B) of the Act requires adoption of an inducement resolution with respect to the Zimmer Facilities before September 26, 1985. The generating facility served by the Zimmer Facilities was originally planned as a nuclear power plant. The construction of the nuclear plant was not completed, and in 1984 the Companies decided to convert the partially constructed plant to a coal-fired facility. In November 1984 the Companies obtained an inducement resolution with respect to the yet-to-be constructed pollution control facilities for the coal-fired facility. However, in reliance on the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii), the Zimmer Facilities were not expressly described in that inducement resolution. In response to the new requirement of Section 1312(a)(1)(B), an amended inducement resolution specifically referring to the Zimmer Facilities was obtained on November 7, 1985, and consequently the Zimmer Facilities have now clearly satisfied Treas. Reg. §1.103-8(a)(5)(ii). Moreover, the Zimmer Facilities would have satisfied the Senate transition rule based on a March 1, 1986 date but do not satisfy the transition rule of the Act based on a September 26, 1985 date.

The unfairness caused by Section 1312(a)(1)(B) of the Act in this case is due to the fact that the new inducement resolution rule was first made public on September 26, 1985, and as a result it became effective immediately, even though under then existing law no such requirement applied to the Zimmer Facilities. It is particularly inequitable to deny tax-exempt financing of the Zimmer Facilities where tax-exempt financing had been contemplated by the Companies well before September 26, 1985, but where an inducement resolution had not been obtained as of that date in reliance on the existing Treasury Regulations.

The foregoing circumstances involve a case where Congress should make a technical correction to the Act that would permit tax-exempt financing on a transition rule basis of a project, such as the Zimmer Facilities, where construction had commenced before September 2, 1972 and was still ongoing on September 26, 1985 and where an inducement resolution was obtained after September 26, 1985. An appropriate technical correction would be one that applied for purposes of Section 1312 of the Act the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii). The following language, added to either Section 1312 or Section 1318 of the Act, would accomplish this purpose:

> In the case of a facility the construction, reconstruction or acquisition of which commenced before September 2, 1972, the requirement of subsection 1312(a)(1)(B) shall be satisfied if an inducement resolution or other

> comparable preliminary approval is adopted by an issuing authority (or by voter referendum) before the date the entire facility is or was first placed in service.

Because Section 1318 contains a number of special rules relating to effective dates and transition rules, it is probably more appropriate to make this correction in Section 1318.

Thank you for your consideration of this matter.

Respectfully submitted,

Jackson B Browning Jr

Jackson B. Browning, Jr.

and paragraph (b) of this section, an insubstantial amount may be used for an industrial or commercial project or for any other purpose that is not functionally related and subordinate to the residential real property for family units.

(4) *Ultimate use of proceeds.* The question whether substantially all of the proceeds of an issue of obligations are to be used to provide one or more of the exempt facilities listed in subparagraphs (A) through (G) of section 103(b)(4) and in this section is to be resolved by reference to the ultimate use of such proceeds. For example, such proceeds will be treated as used to provide residential rental property whether the State or local governmental unit (i) constructs such property and leases or sells it to any person who is not an exempt person for use in such person's trade or business or leasing such property, (ii) lends the proceeds to any such person for such purpose; or (iii) lends the proceeds to banks or other financial institutions in order to increase the supply of funds for mortgage lending under conditions requiring such banks or other financial institutions to use such proceeds only for further lending for residential rental property.

(5) *Limitation.* (i) To qualify under section 103(b)(4) and this section as an exempt facility, such facility (*a*) must be one which is described in subdivision (ii) of this subparagraph and, if the original use of the facility commences prior to the date of issue of obligations issued to provide such facility, the facility is described in subdivision (iv) of this subparagraph or (*b*) if the construction, reconstruction, or acquisition of the facility commences on or after September 2, 1972, the facility is described in subdivision (iii) or (iv) of this subparagraph.

(ii) If the construction, reconstruction, or acquisition of a facility commences before September 2, 1972, the facility is described in this subdivision if a bond resolution with respect to obligations to provide such facility had been adopted by, or some other similar official action toward the issuance of obligations to provide such facility had been taken by, the issuer of such obligations prior to the date the entire facility is first placed in service. The determination as to whether a stage or portion of a single facility, or an entire facility, was placed in service is determined according to the facts and circumstances of each situation. However, the date on which an entire facility is placed in service shall not be earlier than the date on which—

(*a*) It has reached a degree of completion which would permit operation at substantially the level for which it is designed, and

(*b*) It is, in fact, in operation at such level.

For example, a newly constructed air pollution control facility for a manufacturing plant is not first placed in service within the meaning of this subdivision merely as a result of its initial operation at an air pollution abatement level substantially below that contemplated for the complete facility.

(iii) If the original use of a facility commences (or the acquisition of a facility occurs) on or after the date of issue of obligations issued to provide such facility, the facility is described in this subdivision if a bond resolution with respect to such obligations had been adopted by, or some other similar official action toward the issuance of such obligations had been taken by, the issuer of such obligations prior to the commencement of the construction, reconstruction, or acquisition of such facility. Temporary construction or other financing of a facility prior to the issuance of State or local governmental obligations to provide such facility will not cause such facility to be one which is not described in this subdivision.

(iv) If the original use of a facility commences prior to the date of issue of the obligations issued to provide such facility, the facility is described in this subdivision if no nonexempt person or a related person (as defined in section 103(b)(6)(C) and paragraph (e) of § 1.103-10)—

(*a*) Who was a substantial user (within the meaning of § 1.103-11) of such facility at any time during the 5-year period preceding the date of issue of such obligations, and

(*b*) Who receives, directly or indirectly, proceeds of the issue of obligations in question in an amount equal to 5 percent or more of the face amount of the issue (in payment for his interest in such facility)

will be a substantial user of such facility at any time during the 5-year period following such date of issue.

(v) A facility shall not be treated as one not described in subdivision (iv) of this subparagraph by reason of the use of the facility by such substantial user prior to the date of issue of the State or local obligations issued to provide the facility, provided that a bond resolution or other similar official action was taken by such issuer with respect to such obligations (*a*) prior to the commencement of the construction, reconstruction, or acquisition of such facility and such obligations are issued within 1 year after the entire facility was first placed in service was acquired (whichever occurs last), or (*b*) in the case of a facility which is described in subdivision (*ii*) of this subparagraph, prior to the date the entire facility is first placed in service. See subdivision (ii) of this subparagraph for rules for determining when an entire facility is first placed in service. The provisions of this subdivision shall not apply with respect to an acquisition if any substantial user or a related person after the date of such acquisition was a substantial user before the date such bond resolution or other similar official action by such issuer was adopted.

(6) *Deep discount obligations.* (i) Except as otherwise provided in paragraph (a)(7) of this section, the proceeds of any issue of obligations sold by the issuer after June 4, 1982, shall include any imputed proceeds of the issue. The imputed proceeds of an issue equal the sum of the amounts of imputed proceeds for each annual period (hereinafter, bond year) over the term of the issue.

(ii) The amount of imputed proceeds for a bond year equals—

(*a*) The sum of the amounts of interest that will accrue with respect to each obligation that is part of the issue in such year, reduced (but not below zero) by

(*b*) The sum of the amounts of principal and interest that become payable with respect to the issue in that bond year.

(iii) Interest will be deemed to accrue with respect to an obligation on an amount that, as of the commencement of that year, is equal to the sum of—

(*a*) The purchase price (as defined in § 1.103-13(d)(2)) allocable to the obligation and

(*b*) The aggregate of the amounts of interest accruing in each prior bond year with respect to the obligation, reduced by all amounts that became payable with respect to the obligation in prior bond years. Any amount that becomes payable during the 30 day period following any bond year will be deemed to have become payable in such bond year. Thus, to the extent interest on an obligation accruing during a bond year does not become payable within 30 days from the end of such year,

Summary of Statement on the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)

The attached statement describes a technical problem arising out of the generic transition rules of Section 1312 of the Tax Reform Act of 1986 (the "Act") that would prevent the tax-exempt financing of certain pollution control facilities consisting of a cooling tower and related facilities at the Wm. H. Zimmer Generating Station (the "Zimmer Facilities"). The Zimmer Facilities are owned as tenants in common by The Cincinnati Gas & Electric Company, Columbus and Southern Ohio Electric Company and The Dayton Power and Light Company, and the financeable cost of the Zimmer Facilities is not currently expected to exceed $120 million. Because the construction of the Zimmer Facilities began before September 2, 1972, under existing Treasury Regulations, these Facilities could satisfy certain applicable timing requirements if an appropriate "inducement resolution" was obtained before the placement in service date, which has not yet occurred. Under the Act, a generic transition rule requires adoption of an inducement resolution with respect to the Zimmer Facilities before September 26, 1985. That rule was first made public on September 26, 1985, and as a result became effective immediately, even though under then existing law no such requirement applied to the Zimmer Facilities. In response to this new requirement, an inducement resolution specifically referring to the Zimmer Facilities was obtained on November 7, 1985 and consequently the Zimmer Facilities have now clearly satisfied the timing requirements of the existing Treasury Regulations. There is no indication in the legislative history of the Act that Congress intended to repeal this part of the Treasury Regulations with the enactment of the generic transition rules of the Act. It is particularly inequitable to deny tax-exempt financing of the Zimmer Facilities where tax-exempt financing had been contemplated by the Companies well before September 26, 1985, but where an inducement resolution had not been obtained as of that date in reliance on the existing Treasury Regulations. The statement recommends that Congress make a technical correction to Section 1312 or 1318 of the Act that would apply the pre-September 2, 1972 inducement resolution rule of the Treasury Regulations for purposes of Section 1312 of the Act. Because the facts giving rise to this problem are rather unique, it is believed that there are no other similarly affected facilities. Therefore, the suggested correction would have a very limited impact.

The name, address and telephone number of the designated representative of the Companies is:

Jackson B. Browning, Jr.
Squire, Sanders & Dempsey
520 Madison Avenue
New York, New York 10022
Telephone: (212) 715-4990

Section 1313

CIDBI
Council of Industrial Development Bond Issuers
477 H Street, N.W.
Washington, D.C. 20001
202/682-3764

July 17, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C 20515

Dear Mr. Leonard:

On behalf of the Council of Industrial Development Board Issuers (CIDBI), I am writing to provide comments on the "Technical Corrections Act of 1987," H.R. 2636. I would also like to share additional concerns of Council members pertaining to the Tax Reform Act's effects on qualified small issue bonds.

These comments are based on specific issues raised by our membership at our recent conference and post-Act surveys of our membership. CIDBI is an organization of more than 140 public agencies of state and local governments that was formed to promote the continued and effective use of small issue industrial development bonds.

First, CIDBI supports the bill's provisions to further clarify the intent of Congress regarding the refundings of qualified small issue bonds for non-manufacturing facilities. As you know, authority to use small issue bonds for non-manufacturing projects terminated December 31, 1986. As a result of what some perceived as an inconsistency in the 1986 Act provisions, refundings of this previously-eligible category have been made more difficult and in some cases postponed due to uncertainty about applicable provisions of the Code.

The provisions of H.R. 2636 and the Treasury Department's statement should correct any problems associated with such refundings. CIDBI supports the proposed changes and commends the bill's sponsors for taking action to remedy this problem.

Let me note several related issues on refundings. On March 3, the Internal Revenue Service issued a revenue ruling (Rev. Ruling 87-19) disallowing a waiver of the right of bondholders to receive a higher rate of interest if the terms of the bond require such rate adjustments. To do otherwise, according to the IRS ruling, would be deemed an exchange and thus would be considered a reissuance. In view of the legislative uncertainty that often encouraged such rate adjustment provisions in bonds, this seems to be a relatively harsh regulatory reaction given other features of the 1986 Tax Reform Act.

The issue here is the July 1 effective date of the corporate income tax reduction and the associated interest rate hikes that bondholders must impose if so called "gross-up" or other adjustment provisions require it. In almost all cases, the issues are pre-1986 Tax Reform small issue industrial development bonds. The bondholders are predominantly financial institutions. As a result of the IRS ruling, refundings, normally a function of interest rate changes, are in many cases being driven primarily by the July 1 effective date of the corporate income tax rate reduction. Small issue bond borrowers seeking refundings to escape these seemingly artifical adjustments have been frustrated not only by the new 1986 Code requirements related to non-manufacturing projects, but also by Section 265 of the 1986 Code which would deny financial institutions an interest deduction for their expense of purchasing and carrying such tax-exempt bonds. This is a rather "Catch 22" result where Rev. Ruling 87-19 almost compels a refunding, and the financial institution under Section 265 is almost compelled not to purchase the refunding bonds. Certainly, this was not intended.

Thus such small issue bond refundings are driven by date certain interest rate hikes and also have to overcome a significant market impediment. That impediment is the denial under Section 265(b) of the interest deduction for the refunding issue which is Rev. Ruling 87-19 driven. Banks are no longer purchasing such bonds in any significant amount or number. As a result, borrowers relying on either new and refunding bonds must enter markets dominated by purchasers unfamilar with the borrowers and the small issue bond program generally. In some areas, the market has not responded efficiently and there are few, if any, opportunities to seek alternatives to the automatic "gross-up" of interest rates on prior issues.

The key point to be made is that even with the clear refunding authority, such bonds have to seek an entirely new market as a result of the denial of interest expense deductions under Section 265(b) of the new Code.

I would also like to take this opportunity to share with the Committee several issues of concern that may go beyond the Chairman's announced intentions to consider only technical corrections. I would hope the Committee will consider these issues at the appropriate time so that new qualified small issue bonds can more effectively be used to further important national economic development objectives.

First, I would urge the Committee to clarify and correct the "manufacturing facility" definition, and the surprisingly restrictive interpretation that surfaced for the first time in the "blue book" for the Tax Act of 1984. Now that definition, as a result of the 1986 Tax Act, has been frustrating projects since January 1, 1987.

CIDBI's post-1986 Tax Act survey, conducted during the first quarter of 1987, demonstrated significant problems in practical application of small issue bond authority due mainly to the manufacturing facility definition. Issuers and bond counsel have had difficulty in making the very basic determinations of project eligibility for certain facilities.

For issuers, knowing more readily what projects are eligible would help overcome an initial impediment for borrowers and could eliminate unneeded legal costs, particularly for smaller businesses. Additionally, a clarifying amendment would help agencies focus on the more difficult task of accessing the market.

The loss of banks in the market has compelled issuers to seek pooled financings in order to both lower costs for borrowers and to access new markets. Such markets are generally public. To undertake pooled or composite issues, certain and quick determinations of eligibility are essential. Assembling a pool of borrowers as part of a single pooled issue, on the same schedule, is difficult enough. As you know, the tax-exempt status of the entire pool is tied to the tax-exempt eligibility of each of the individual projects. Clear issuing authority is of critical importance to potential purchasers of these pooled financings and for compliance with provisions of the Act, especially in public markets.

CIDBI urges the Committee to consider, for example, using the Standard Industrial Classifications (SIC) for "manufacturing" to clarify the current definition. Since the IRS is not expected to issue timely regulations on the current definition, the use of SIC codes for manufacturing would certainly facilitate issuers' efforts and subsequent actions by IRS to make individual determinations as well.

The Council also urges the Committee to provide clarification of the existing manufacturing definition for eligibility for small issue bond financing. There are several key reasons for this recommendation:

- o State and local governments need more flexibility to facilitate investments in direct manufacturing projects and related manufacturing facilities. More clear authority would help issuers further federal objectives to promote capital formation and competitiveness in the broader manufacturing sector.

- The existing definition, which was given a surprisingly restrictive interpretation in the "blue book" explanation of the 1984 Act, has not been updated to reflect present needs of manufacturing firms and related activities.

- Finally, the survival and competitiveness of manufacturing firms is no longer simply tied to purely manufacturing activities, and Congress in its recent actions has underscored the importance of related activities, such as research and development.

CIDBI is ready to provide specific recommendations to the Committee concerning the basis for a more workable "manufacturing facility" definition.

Finally, because of volume limits on the issuance of private activity bonds, modification of the definition could not increase any projected federal revenue losses. In addition, based on our review of the state bond volume limitations and expected demand, bond issuance during 1987 will occur at levels below that assumed by the Committee during last year's debate. This underutilization, due to a number of factors, will reduce assumed tax expenditures in 1987, yielding savings which will be compounded over the next several years. An amendment to the "manufacturing facility" definition could be enacted consistent with the Chairman's stated objectives of not adding amendments to H.R. 2836 which would cause any further loss of revenue.

The effects of the Act on the market for small issue bonds are dramatic. The elimination of the interest expense deduction for banks under Section 265(b) for purchases of qualified small issue bonds has been devastating on the market for this category of tax-exempt bonds. Very few issuers have yet even issued a single small issue bond during 1987.

According to CIDBI's national study of the program, released in January 1986, banks accounted for nearly 90% of all small issue bond purchases. This traditional market, dominated by local banks, passed through the benefits of the 80% interest deduction directly to the borrowers through lowered interest rates. For borrowers, the denial to banks of the interest expense deduction under Section 265(b) translates into higher borrowing costs. This is especially true for small businesses and manufacturing firms that require special incentives and for borrowers generally. In many cases, qualified small issue bonds financing often determines whether or not some of these targeted projects move forward.

The effective unavailability of qualified small issue bond financing has essentially done away with almost all smaller community economic development programs. The money markets simply do not respond well to $500,000 - $1,000,000 project financings. Local banks often do.

We would also note that the inability of banks to deduct the interest expenses of purchasing and carrying private activity bonds is in many cases based on a false premise. Most small issue bonds are the result of banks extensively working with the borrowers, devising and assisting with financial and business plans, especially as to smaller projects. These are issues where banks perform "due diligence," extensive loan review, and provide other related services. These banks do not rely on securities laws for protection. They are not buying in a market like individuals do. In these cases of extensive bank involvement in the analysis of the credit and the project, the banks have earned the right to deduct for their purchasing and carrying costs of such bonds. In the case of such extensive bank involvement with the borrower and project, the comparison to individuals inability to deduct such purchase and carrying costs is inappropriate. After all, individuals generally are buying in recognized markets and realize more of the protections of securities laws. Somehow this analysis did not enter into the debate on the 1986 Act.

The loss of the interest expense deduction for banks under Section 265(b), combined with other new limitations, has disproportionately affected smaller borrowers and others most in need of affordable capital. CIDBI, since its inception, has been working with its member agencies to target small issue bonds increasingly toward smaller businesses, a category of borrower which can yield real opportunities for new job creation and other real benefits for the nation. This emphasis on smaller businesses also complemented Congress' earlier efforts, as provided for in the 1982 and 1984 Acts, to limit eligibility to smaller firms as well. Under the array of new rules under the 1986 Tax Act affecting small issue bonds, this emphasis on smaller issues is not possible.

The initial effects of the market-related provisions of the 1986 Act have resulted in squeezing the smaller projects out of the small issue program. Now small issue bonds to assist these businesses must be brought to the public markets. The cost of credit enhancement and other transaction costs are such that issues of less than $2 million, at the top range, cannot be sold individually. The public markets generally are not responsive to these smaller issues. Such smaller financings can move forward as part of pooled programs, but generally issues of less than $1 million are still not viable.

CIDBI and its members are working to create alternative and innovative programs to respond to the market-related provisions of the Act. There are several successful programs that indicate the market will adjust. However, for certain smaller borrowers and in certain areas of the country, it is not likely that the Act's unintended bias against smaller borrowers and issues can be offset in the immediate future, if at all.

I would like to note our concerns about the state bond volume limitations. In the immediate post-1986 Act environment, all bond activity has slowed to the point that the full effects of the volume cap have been dramatically understated. Small issue bonds have slowed reflecting the loss of the bank market and the counter-cyclical nature of the program. In the early 1980's, particularly, it helped ensure that economic activity, that would not have occurred otherwise, could go forward. During that cycle, the program really helped businesses, particularly smaller ones that were shut out of the market, to borrow capital and undertake projects vital to the business, its community and the nation's economy.

Finally, CIDBI urges the Committee to reconsider the Dec. 31, 1989 small issue bond sunset at the appropriate time in light of the significant public benefits of the program as a tool to promote small business development, stimulate capital formation, to help lower trade deficits, and further competitiveness of the nation's businesses.

CIDBI appreciates the opportunity to share these concerns with the Committee and we look forward to working with the Committee on technical corrections and other legislation.

Sincerely,

James J. Hughes Jr.

James J. Hughes, Jr.
CIDBI President

MEMORANDUM

July 17, 1987

Origination of Mortgage Loans with Proceeds of Tax-Exempt Single Family Mortgage Revenue Bonds -- Page 244 of the Description of the Technical Corrections Act of 1987 (H.R. 2636 and S.1350) Prepared by the Staff of the Joint Committee on Taxation

The Board of the Texas Housing Agency (the "THA") has under consideration a proposed bond issue to refund certain of its outstanding single-family mortgage revenue bonds ("SFMRBs"). This refunding would permit THA to make additional mortgage loans funded from amounts that represent prepayments of mortgage loans that were funded with proceeds of the prior issues being refunded.

Refunding bonds are necessary to accomplish this result because the carrying costs (i.e., interest costs of the prior issue) of the pool of prepayment funds would not permit a below-market mortgage rate. However, the reduced interest rate of the refunding bonds will reduce the carrying costs so as to permit the origination of mortgages at a below-market rate.

The THA is concerned about a sentence that appears on page 244 of the Description of the Technical Corrections Act of 1987 prepared by the Staff of the Joint Committee on Taxation. That sentence states as follows:

> As was stated in the legislative history accompanying the Act for refundings occurring before January 1, 1988, refundings permitted under this expansion of the transition exception [i.e., 1988 refundings] may not involve an extension of the period for providing financing for homebuyers.

The statement in the legislative history of the 1986 Act to which the above-quoted sentence is apparently referring is a sentence on page II-716 of the Conference Committee Report accompanying the 1986 Act which states as follows:

> The conferees intends that, as under present law, the period allowed to provide financing for qualified mortgagors in the case of these current refunding bonds [i.e., single-family mortgage revenue bonds], be determined from the date of issue of the refunded bonds (the original bonds in the case of a series of refundings), rather than a new period commencing on the date of the refunding (emphasis added).

This statement in the legislative history has generated some confusion recently.

On the one hand, practitioners have interpreted this sentence in the Conference Committee Report to refer to rules governing temporary periods (i.e., periods during which proceeds can be invested at unrestricted yields pending their use for their intended purpose). These temporary period rules clearly do carry over into existing law. Under those rules, refundings do not extend temporary periods beyond the periods which were otherwise available to proceeds of the prior issue being refunded. The quoted sentence was interpreted simply to confirm the continuation of that rule. That was the only interpretation under which any meaning could be given to the "present law" reference in the Conference Committee Report sentence quoted above.

On the other hand, Hill staff have recently indicated that this sentence was, in fact, intended to refer to a limit on the period during which proceeds of a SFMRB can be used to originate mortgage loans, separate and apart from temporary period rules. However, it is believed that Hill staff will acknowledge that there is no prior law basis for a restriction on origination periods, and there is no statutory basis in the 1986 Reform Act or the Technical Corrections Bill for such a restriction. Therefore, Hill staff have suggested that it may be necessary to amend the statutory language of the pending Technical Corrections Bill if this sentence is to have any clear legal significance.

If debate is had in the Congressional tax-writing committees whether the 1986 Code should be amended to impose a limit on the period during which proceeds of SFMRBs can be used to originate mortgage loans, THA has a number of points that it wishes to make.

1. There is No Apparent Policy Logic that would Support Limitations on Origination Periods.

A. A limitation on origination periods for SFMRBs is not necessary to curb issue size. Between 1980 and August, 1986, SFMRBs were subject to an annual statewide volume cap equal to 9% of the average annual amount of mortgages originated in the State during the preceding three years (with a $200,000,000 floor for smaller states). See section 103A(g)(4) of the 1954 Code. By virtue of being tied to historical annual demand for mortgage money, this ceiling served the purpose not only of limiting volume in an absolute sense, but also limited the extent to which issuers could size bond issues relative to projected annual demand (particularly in the case of statewide issuers such as THA). Under the 1986 Code SFMRBs are subject to the "unified" state volume cap rules. Although the unified volume cap has no explicit mortgage demand criterion, the difficult allocation choices among different purposes forced upon a state by the admittedly stringent volume limit will also operate to prevent issue sizes in excess of expected near-term demand.

B. A limitation on origination periods for SFMRB proceeds would deprive issuers of the flexibility necessary to ensure maximum realization of the intended benefit of their programs. The intended benefit of tax-exempt SFMRB programs, from both a federal and local government perspective, has been to provide a limited incentive for home ownership by making available below-market interest rates on mortgage loans. The principal factor which causes delays in origination (and thus affects the length of the origination period for SFMRB proceeds) is post-issuance market downturns in mortgage rates -- a factor over which an issuer has no control.

Rates on mortgages originated under SFMRB programs generally must be fixed at the time of bond issuance in order to assure sufficient revenues to repay bonds and to assure compliance with applicable arbitrage requirements. 1/ If subsequent to the establishment of the mortgage rate, a general downturn in interest rates starts to push the conventional mortgage rate down to or below the SFMRB rate, all or some part of the intended benefit of the program disappears until such time as the carrying costs of the unoriginated or prepaid funds can be reduced to reflect current tax-exempt rates. The only means of accomplishing the reduction in bond rates is by refunding an amount of bonds equivalent to the amount of unoriginated funds.

For the last several years mortgage rates in the United States have been on a generally downward trend. Therefore,

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1/ A very few SFMRB programs have provided for bonds that can be remarketed during the origination period at then-current rates. However, the legal and administrative complexities of such transactions have made them all but unworkable.

SFMRB issuers have found it necessary to undertake refundings in order to provide intended beneficiaries of their program with the intended benefit. 2/

2. Treasury Regulations governing SFMRBs have always specifically authorized a SFMRB program to originate (with no time limitation) new mortgage loans from funds representing prepayments of previously originated mortgage loans. Treas. Reg. §1.103A-2(i)(3)(ii)(A) grants a "temporary period" for unrestricted investment to:

> Proceeds (including prepayments of principal designated to be used to acquire additional mortgages) of the issue invested for an additional temporary period not to exceed 1 year . . . (emphasis added).

For the same reasons discussed above relating to interest rate trends and the fixed-rate nature of SFMRB programs, the relending of funds representing prepayments must, in many instances, be preceded by a refunding in order to be viable.

3. The limitation on maturities which is a condition to the applicability of the refunding transition rule of section 1313(a) operates as a practical limitation on origination periods. Under that rule, refunding bond maturities may not extend beyond 32 years from the date the original bond was issued. Therefore, at some point a SFMRB program which reduces carrying costs through refundings would also have to reduce the term of mortgage loans below a term which would be attractive to homebuyers.

CONCLUSION

For the foregoing reasons, THA believes it is neither necessary nor advisable to adopt rules which limit the periods during which mortgages can be originated from SFMRB programs with original or prepayment proceeds.

If for some reason it is determined that such rules are necessary, it would not be fair to apply it to outstanding bonds that have funded SFMRB programs (or to refundings of such outstanding bonds) inasmuch as those bonds were issued with the expectation of continued flexibility under existing law (unchanged from prior law) relating to origination periods and refundings to reduce carrying costs. That flexibility should not be retroactively denied.

Supplemental Information

This statement is submitted by Charles L. Almond and Michael A. Jungman of VINSON & ELKINS, 1455 Pennsylvania, N.W., Washington, D.C., 20004-1007, telephone number (202) 639-6500, on behalf of the TEXAS HOUSING AGENCY.

2/ The application of State ceiling rules to refundings designed to lower the carrying cost of proceeds that had not been used to finance mortgage loans was the subject of two letter rulings. In LTR 8434092 the Service ruled that such a refunding would count against the State ceiling in the year in which the refunding bonds were issued. Subsequent to that ruling, there were colloquies on the floor of the House of Representatives and the floor of the Senate, and subsequent to those colloquies the Service reversed its position in LTR 8540090 and ruled that refundings relate back to the refunded bonds with no new state ceiling consequences. A large number of refundings have been undertaken with legal opinions based on the same reasoning contained in the second ruling.

Section 1316

COMMENTS ON H.R. 2636
THE TECHNICAL CORRECTIONS ACT OF 1987
PRESENTED TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY RAYMOND T. SCHULER, PRESIDENT
THE BUSINESS COUNCIL OF NEW YORK STATE, INC.
JULY 16, 1987

The Business Council of New York State, Inc. is the largest broad-based business group in New York State, representing over 3,500 companies and nearly 200 local and regional chambers of commerce from throughout the State. The following comments detail initiatives which we strongly support as vital to meeting the future energy needs of Long Island.

H.R. 2636, the Technical Corrections Act of 1987, contains a provision (amending section 1316 (g)(8) of the 1986 Tax Reform Act) that allows the New York Power Authority to issue bonds under the state's tax-exempt bond volume limitation cap using carryforward provisions.

The 1984 Deficit Reduction Act and the Tax Reform Act of 1986 authorized the Power Authority to issue up to $911 million in tax exempt bonds within the limits of the annual state cap. The Technical Corrections Act contains a provision that will allow the Authority to carryforward state authorized bonding allocations and thereby assure New York's maximum use of it's federally prescribed limit.

One of the projects to be financed through the issuance of the bonds provided through the 1984 and 1986 Acts is a 345 - kilovolt underground and underwater transmission cable from Westchester to Long Island. The cable is designed to increase the reliability of Long Island's power supply by nearly doubling the capacity of its transmission ties to neighboring electric systems.

Another correction needs to be made in addition to the future carryforward ability provided in the bill. The carryforward election for the Long Island Cable Project made by the Power Authority in 1985 apparently does not meet the criteria contained in the 1986 Act necessary to be considered an eligible carryforward. The construction of the cable is essential to economic health of the ratepayers of Long Island, who currently pay some of the highest electric rates in the nation. Without additional language specifying that the carryforward is eligible, New York faces the loss of $106.5 million for this essential project.

The Business Council of New York State, Inc. appreciates your efforts in obtaining language in H.R. 2636 which clarifies the prospective use of the carryforward provision for Power Authority bonds. In addition, we are hopeful that language will be added to the bill which will preserve the $106.5 million in carryforward previously elected for the Long Island Sound Cable project.

We appreciate your consideration of our comments.

STATEMENT ON H.R. 2636
TECHNICAL CORRECTIONS ACT OF 1987
PRESENTED TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY RICHARD FLYNN, CHAIRMAN
NEW YORK POWER AUTHORITY
July 10, 1987

Mr. Chairman. The New York Power Authority is a statewide public power agency that operates hydroelectric, nuclear, and fossil fuel power plants in New York. It was created by state law in 1931 during the administration of Governor Franklin D. Roosevelt. Currently, the Authority produces and sells more electric power than any of the other 2,144 state and local publicly-owned power agencies in the United States. As Chairman of the Authority, I would like to submit to the Committee the following comments on the Technical Corrections Act of 1987, H.R. 2636.

Section 113(f)(A) of H.R. 2636 clarifies that bonds issued by the New York Power Authority under the provisions of section 629 of the 1984 Deficit Reduction Act, as amended by section 1316(g)(8)(A) of the 1986 Tax Reform Act, are eligible for carryforward elections under New York State's tax-exempt bond volume limitation cap. We are most pleased that the Committee has included this provision in H.R. 2636 and we believe this technical correction is in keeping with the Congressional intent of section 629, as amended.

Section 629 was included in the 1984 Deficit Reduction Act to clarify the tax treatment of certain bonds issued by the New York Power Authority. The clarification was necessary due to certain unique aspects of the Authority's operations. The Authority does not own its own local distribution lines and as a result must sell its electricity wholesale through the

State's seven private utilities, which serve 98% of New York's electric customers. The Authority contracts with the private utilities to carry its power through their distribution lines for sale to end-use customers, at no markup in cost. Without its own distribution lines, contracting with private utilities to deliver its power is the only way the Authority can serve 98% of New York's electric power consumers. However, because the Authority enters into contracts with private utility companies, its bonds are subject to being classified as taxable "private purpose" bonds. Recognizing the unique circumstances under which the Authority operates, Congress added Section 629 to the 1984 Deficit Reduction Act clarifying that certain bonds issues by the Authority are to be treated as tax-exempt "public purpose" or governmental bonds.

Section 629 of the Deficit Reduction Act of 1984 authorized the Authority to issue up to $625 million of tax-exempt bonds for certain electrical generation and transmission facilities. The 1986 Tax Reform Act amended section 629 of the 1984 act to increase to $911 million the amount of tax-exempt bonds authorized to be issued and to define additional categories of projects for which such bonds can be issued.

However, while the statutory language of section 629 treats the bonds as "public purpose" or governmental bonds, the 1984 Act agreement made bonds issued under section 629 subject to the state volume cap limitation. It was our assumption at the time that for the purposes of the volume limitation cap, the carryforward provisions of the Internal Revenue Code would apply to section 629 bonds. This interpretation, however, appears to need clarification. Section 113(f)(A) of H.R. 2636 clarifies the issue for future carryforward elections by making the carryforward provisions in the 1986 Tax Reform Act explicitly applicable to bonds issued after 1986 under section 629 of the Deficit Reduction Act, as amended.

There remains, however, an outstanding issue. Based upon our understanding of the 1984 provision, we believed that allocations of New York's volume cap could be made immediately on a carryforward basis to the Authority for the specified purposes of section 629, particularly for the Long Island Sound Cable facility, which we knew would take several years to design, license, and complete.

The Long Island Sound Cable facility is a transmission line running under Long Island Sound between Westchester and Long Island which will carry about 600,000 kilowatts of lower-cost electricity from upstate New York and Canada to Long Island. Construction of the cable is expected to take place over a three-year period and the capital cost is estimated to be $317 million in 1991 dollars. The cable facility is critical to increasing the reliability and mitigating the cost of electric power on Long Island. Use of tax-exempt bond financing for the facility will save Long Island ratepayers approximately $225.5 million over the life of the bonds.

The Long Island Sound Cable is currently in the pre-licensing phase. Because of the importance of this project, New York State allocated $106.5 million of its 1985 volume cap for the Long Island Sound cable. The carryforward election was made in accordance with then-applicable regulations. Under the circumstances at the time, and because Section 619 bonds were "Public purpose" bonds, there was no reason to believe that such a carryforward election might be declared invalid. It now appears, however, that certain provisions in the 1986 Tax Reform Act would negate the Authority's 1985 carryforward of $106.5 million for the Long Island Sound Cable.

In closing, we would like to thank the Committee for including Section 113(f)(A) in H.R. 2636 clarifying the Authority's ability to make future use of the carryforward provisions of the 1986 Tax Reform Act. We remain concerned, however, about the potential loss of our carryforward for the Long Island Sound Cable and hope that the Committee will consider resolving this issue by adding an amendment to H.R. 2636 explicitly authorizing the $106.5 million carryforward.

I appreciate the opportunity to present to the Committee the New York Power Authority's comments on H.R. 2636 and would like to thank you for your consideration of this matter.

Prudential-Bache Capital Funding

Public Finance Department

July 15, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: H.R. 2636, the Technical Corrections Act of 1987

Dear Mr. Chairman:

I am writing to request your consideration of a clarification to the 1986 Tax Code whicn is of great consequence to the new State Revolving Fund program authorized pursuant to the "Water Quality Act of 1987", Public Law 100-4. There is a need to clarify the tax treatment of "leveraged" state obligations issued for water pollution control state revolving funds, perhaps as part of the pending technical corrections legislation.

In general, any state or local obligation that is "federally guaranteed" is not exempt from federal income tax. The tax code (I.R.C. §149) defines "federally guaranteed" broadly to include any obligation where the payment of principal or interest is guaranteed, either directly or indirectly, by the United States. Exceptions are provided in the Code for certain insurance, debt service, and housing programs. No regulations have been issued by the Treasury to provide further guidance on this matter.

The Joint Committee on Taxation, in its explanation of the 1984 Deficit Reduction Act, indicated that the Congress intended that the determination of whether a Federal guarantee exists be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances. The transfer of risk to the Federal Government is a key element in determining whether a guarantee exists relating to the issuance of the obligations.

Also, the code (I.R.C. §103) provides that any state or local obligation issued to acquire materially higher yielding investments or to replace funds used for such purpose is deemed to be an "arbitrage" bond and is not exempt from federal income tax. Reserve or replacement funds (including "sinking funds" or debt service funds used to pay principal or interest on an issue) are not arbitrage bonds where only a minor portion (does not exceed 10%) of the face amount of the original issue invested at a higher yield or where "temporary period" rules apply.

Problems

Concerns have been expressed with regard to the effect of these limitations on the new State Revolving Fund ("SRF") program established by the 1987 Clean Water Act Amendments, Public Law 100-4 ("CWA"). A key element of the program is the shifting of federal water pollution control financing to the States, replacing the former federal construction grant approach with federal "seed money" (capitalization grants). Beginning in Fiscal Year 1989, as a precondition to receiving this seed money, States must establish a revolving fund as a source for loans, or to be "leveraged" and used as a revenue source or security for State issued obligations to permanently expand the fund (CWA #603 (d) (4)).

o Where the federal capitalization grant deposited in the State revolving fund is used as a security for obligations issued by a State, the Internal Revenue Service might disallow the tax exemption. The Service might argue that the federal funds will be used as collateral for the obligations, transferring risk from the State, thus acting as a "federal guarantee". On the other hand, it can be argued that, once deposited, the federal grant becomes a State fund and is not a federal guarantee.

o Where the State issues obligations, and the proceeds of the sale of such obligations are deposited in the State Revolving Fund and used as a revenue source to pay principal and interest, the Service might argue that the proceeds are "invested sinking funds" and that the obligations may be taxable "arbitrage" bonds. However, the mechanism can also be a required reserve or a debt service fund used to achieve a proper matching of revenues and debt service.

Treasury has indicated that a revenue ruling would be needed to resolve these uncertainties absent legislation. This could delay full implementation of the plan to shift water pollution control financing to the states by perhaps two-years or more. While a few states have already established revolving fund programs, the vast majority of states will begin early next year to implement such plans in view of the October 1988 deadline.

Proposal

The tax code should be clarified to provide:

(1) that a State revenue or general obligation shall not be treated as "federally guaranteed" by reason of the fact that a federal capitalization grant for a State water pollution control revolving fund is used as a source of security for the payment of principal and interest on such obligations; and

(2) those circumstances under which a State revenue or general obligation shall not be treated as an "arbitrage" bond where a major portion of the proceeds of the sale of such obligations will be deposited back into the State water pollution control revolving fund and used as a revenue source to pay principal and interest on the obligations.

Mr. Chairman, thank you for reviewing this request. Any assistance that you can provide would be greatly appreciated by the nation's municipal waste-water treatment community. Please let me know if you or your staff have any questions about this matter.

Sincerely,

William B James

William B. James, C.F.A.
Associate Director

CITY OF SAINT PAUL

minneapolis
city of lakes

July 15, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1100 Longworth House Office Building
United States House of Representatives
Washington, D. C. 20515

Dear Mr. ~~Chairman:~~ Dan

The Technical Corrections Act of 1987, H. R. 2636, Section 113(f)(5) amending Section 1316(g)(6) of the Tax Reform Act of 1986 is critical to the Minneapolis Community Development Agency and the Saint Paul Housing and Redevelopment Agency.

Section 1316(g)(6) exempts bond issues described in Section 216(b)(3) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and from the Tax Reform Act of 1986. Section 216(b)(3) exempts bonds listed in Section 1104(n) of the Mortgage Subsidy Bond Tax Act of 1980 from Section 103A of the Internal Revenue Code of 1954. Under the transition rule in Section 1104(n) of the Mortgage Subsidy Bond Tax Act, the Saint Paul HRA and the Minneapolis CDA issued $125 million in single family mortgage revenue bonds in June, 1984. In August of 1986, these bonds were converted from floating rate bonds to fixed rate bonds, a transaction which was characterized for technical reasons as a current refunding. At the time of the refunding, the Tax Reform Act was in conference. Bond counsel advised on information provided by their Washington Representative that Section 1316(g)(6) of the bill would, with a high degree of certainty, remain in the conference report. We relied on this advice in refunding. We also relied on information that staff intended Section 1316(g)(6) to exempt projects listed in Section 1104(n) of the Mortgage Subsidy Bond Tax Act of 1980 from arbitrage rebate requirements in the remainder of the Tax Reform Act.

After enactment of the Tax Reform Act of 1986, our bond counsel advised us of Section 1314 of the Act which appeared to override Section 1316(g)(6) with respect to arbitrage rebate requirements. Relying on statements from staff that Section 1316(g)(6) was not subject to the provisions of the Act, we anticipated the technical correction in Section 113(f)(5) of H.R. 2636.

Therefore, we are writing to advise you of our keen interest in retention of this section without amendment, and our support of the bill. We have also communicated our concerns to Senator Durenberger and Congressman Frenzel.

Should you have questions regarding the above, please feel free to call any of the following: Richard Martin, bond counsel at Briggs and Morgan (612/291-1215); Peg Thompson, the Washington representative of the Saint Paul HRA and Minneapolis CDA (202/429-8883); Jay Jensen, Minneapolis CDA (612/348-7100); Ken Johnson, Saint Paul HRA (612/228-3357).

Very sincerely yours,

George Latimer
Mayor, Saint Paul

Donald Fraser
Mayor, Minneapolis

Section 1317

Proposed Technical Correction For The Andover, Massachusetts Town Hall in Regard To Section 1317 (27)(I) Of The 1986 Tax Reform Act And The Technical Correction Contained In Section 113(g)(27) of H.R. 2636.

The Town of Andover, Massachusetts greatly appreciates the efforts of the United States Congress in providing a transition rule for the purpose of providing tax exempt bond financing for the restoration and rehabilitation of its Town Hall which was built in 1858. The Town of Andover received a transition rule in Section 1317(27)(I) of the Tax Reform Act of 1986 to provide for tax exempt bonds to assist in restoration and rehabilitation of this historic facility. A copy of the transition rule is attached. When the transition rule was obtained no one foresaw the capital expenditure limitation for small issue bonds as a problem because of the uniqueness of the project.

After the citizens of Andover approved the bonds for the project, it became apparent that a technical correction was necessary. Bond counsel and the Internal Revenue Service believed the provision would not fully exempt the facility from certain limitations which apply to qualified small issue bonds.

The principal user of the rehabilitated Town Hall will be the federal government because the United States Post Office will be the major tenant of the restored building. The post office was one of the original tenants in 1858. Because the Town Hall will be used by the Federal government (which is a non-exempt person for purposes of the Internal Revenue Code of 1986 (the "Code")), the bonds issued to finance the project must be issued as "qualified small issue bonds" under Section 144(a) of the Code. It is necessary under Section 144(a) to calculate capital expenditures with respect to all other facilities located in the same municipality the principal user of which is or will be the same as the principal user of the bond-financed facilities, over a six year period beginning three years before the date of the bond issue and ending three years after such date. The face amount of the qualified small issue bonds, together with all such capital expenditures, cannot exceed $10,000,000. Therefore, all capital expenditures with respect to other facilities of the federal government located in Andover must be examined because they must be aggregated with the principal amount of the bonds.

The technical correction as introduced in H.R. 2636 Section 113(g)(27), as discussed below, provides for a technical correction which exempts the capital expenditures related to the Internal Revenue Service Regional Service Center located in Andover from the capital expenditure limitation. Andover had requested in letters to members of the Massachusetts delegation that Section 144(a) relating to qualified small issue bonds not apply to the project because Andover knew that the federal government probably spent in excess of $10,000,000 on the Regional Service Center. A copy of the proposed language as contained in the summary to the delegation is attached which was submitted to Senators Kennedy and Kerry and Congressmen Atkins, Conte and Donnelly.

Andover's bond counsel is concerned that other federal facilities or projects may also have capital expenditures that will count towards the $10,000,000 capital expenditure limitation. The other facilities in Andover in which the federal government has incurred or will incur capital expenditures are the present post office on Main Street and two post office substations in

Shawsheen and Ballardvale, and a new replacement postal facility presently under construction. In addition, the published and private rulings by the Internal Revenue Service define the term "capital expenditures" so broadly that many other expenditures by the federal government may have to be taken into account.

In general, the term "capital expenditures" includes all costs which are or might be capitalized under any accounting theory or tax provision. Thus, in determining whether the $10,000,000 limit is exceeded, the Town might have to include not only expenditures with respect to offices and other facilities of any other federal agencies located in Andover, but also federal funds for the interstate highways located in Andover, all federal grants and loans made with respect to facilities or other projects or undertakings in Andover, and possibly even federal contracts awarded to government contractors located in Andover. It would be difficult enough to try to calculate the amount of all such expenditures by the federal government in Andover over the past three years. It will be impossible to keep track of, and restrict, if necessary, the amount of such expenditures by the federal government over the next three years, in order to make sure that the aggregate of such expenditures, when taken together with the principal amount of the bonds, does not exceed $10,000,000. If the federal government were to incur additional capital expenditures with respect to other facilities in Andover during the three year period after the bond issue, causing the $10,000,000 limit to be exceeded, the single bond issue for the Town Hall would automatically lose its tax-exempt status at that point. Since the Town of Andover cannot control, and would not want to limit, future capital expenditures by the federal government in Andover, the only solution that would assure continued tax exemption for the bonds would be to exclude all such capital expenditures by the federal government from the $10,000,000 limit.

However, we are deeply concerned that the term "capital expenditures" may be broadly defined by the Internal Revenue Service to include all federal funds spent in Andover and possibly prohibit tax exempt financing for the Town Hall.

In addition, under Code Section 144(a)(10) a $40,000,000 limit is imposed on all other tax exempt bonds issued to finance other facilities owned or used by the same principal user, in this case the federal government. Such other bonds will have to be aggragated with these bonds and would have to be less than the $40,000,000 limit for these bonds to remain tax exempt. Accordingly, the technical correction must also exclude such other tax exempt bonds allocable to the federal government.

Andover respectfully requests that the technical correction as contained in Section 113(g)(27) of H.R. 2636 be amended to read as follows:

> (27) Subparagraph (I) of section 1317(27) of the Reform Act is amended by adding at the end thereof the following: "For purposes of determining whether any bond to which this subparagraph applies is a qualified small issue bond, there shall not be taken into account under section 144(a) of the 1986 Code capital expenditures with respect to any ~~internal revenue service center~~ facilities of the United States government and all other tax exempt facility-related bonds allocable to the United States government."

This proposed technical correction would eliminate any concern in the future for expenditures that may be undertaken by the federal government in Andover or tax exempt bonds that may be issued for facilities that may be used by the federal government that might affect the tax exempt status of the bonds.

Andover is not requesting any additional funds but is only requesting that Congress' intent to provide tax exempt funding for this small but important restoration project be fulfilled.

Respectfully submitted,

Of Counsel:

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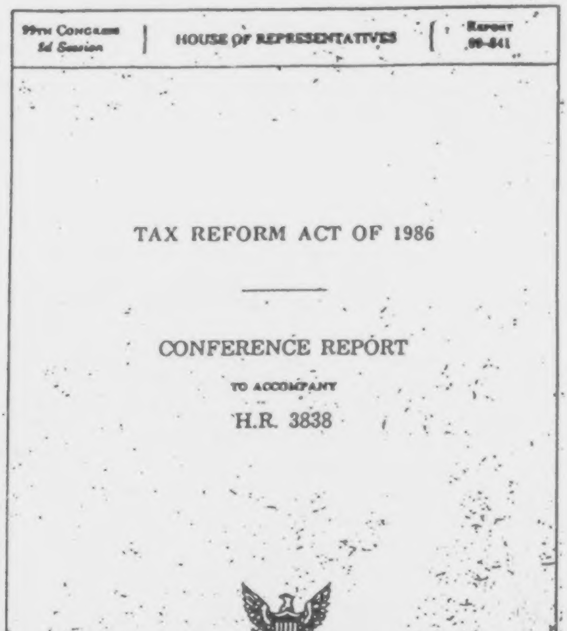

99th Congress
2d Session

HOUSE OF REPRESENTATIVES

Report
99-841

TAX REFORM ACT OF 1986

CONFERENCE REPORT

TO ACCOMPANY

H.R. 3838

Volume I of 2 Volumes

September 18, 1986.—Ordered to be printed

The aggregate face amount of obligations to which this subparagraph applies shall not exceed $8,500,000.

(I) A facility is described in this subparagraph if it consists of the rehabilitation of the Andover Town Hall in Andover, Massachusetts. The provisions of section 149(b) of the 1986 Code (relating to federally guaranteed obligations) shall not apply to obligations to finance such project solely as a result of the occupation of a portion of such building by a United States Post Office.

(J) A facility is described in this subparagraph if it is the Central Bank Building renovation project in Grand Rapids, Michigan. The aggregate face amount of obligations to which this subparagraph applies shall not exceed $1,000,000.

(28) CERTAIN PRIVATE LOANS NOT TAKEN INTO ACCOUNT.—For purposes of determining whether any bond is a private activity bond, an amount of loans (but not in excess of $75,000,000) provided from the proceeds of 1 or more issues shall not be taken into account if such loans are provided in furtherance of—

(A) a city Emergency Conservation Plan as set forth in an ordinance adopted by the city council of such city on February 17, 1983, or

(B) a resolution adopted by the city council of such city on March 10, 1983, committing such city to a goal of reducing the peak load of such city's electric generation and distribution system by 553 megawatts in 15 years.

(29) CERTAIN PRIVATE BUSINESS USE NOT TAKEN INTO ACCOUNT.—

(A) The nonqualified amount of the proceeds of an issue shall not be taken into account under section 141(b)(5) of the 1986 Code or in determining whether a bond described in subparagraph (B) (which is part of such issue) is a private activity bond for purposes of section 103 and part IV of subchapter B of chapter 1 of the 1986 Code.

(B) A bond is described in this subparagraph if—

(i) such bond is issued before January 1, 1993, by a State admitted to the Union on June 14, 1775, and

(ii) such bond is issued pursuant to a resolution of the State Bond Commission adopted before September 26, 1985.

(C) The nonqualified amount to which this paragraph applies shall not exceed $150,000,000.

(D) For purposes of this paragraph, the term "nonqualified amount" has the meaning given such term by section 141(b)(8) of the 1986 Code, except that such term shall include the amount of the net proceeds of an issue which is to be used (directly or indirectly) to make or finance loans (other than loans described in section 141(c)(2) of the 1986 Code) to persons other than governmental units.

(30) VOLUME CAP NOT TO APPLY TO CERTAIN FACILITIES.—For purposes of section 146 of the 1986 Code, any exempt facility bond for the following facility shall not be taken into account: The facility is a facility for the furnishing of water which was authorized under Public Law 90-537 of the United States if—

PROPOSED TECHNICAL CORRECTION OF Section 1317 (27)(I) THE TAX REFORM ACT OF 1986

The Town of Andover, Massachusetts received a transition rule under Section 1317 (27) (I) from the Tax Reform Act of 1986 to assist in the restoration and rehabilitation of the Andover Town Hall built in 1858. The rehabilitation is to retain the integrity of design, materials, workmanship, and setting of the old town hall and to utilize the facility as a post office.

The transition rule provided for an exemption from Section 149(b) of the 1986 Code relating to federally guaranteed obligations but did not exempt the project from Section 144 regarding the $10 million on capital expenditures limitation for small issue bonds in a municipality by a "principal user". The Town of Andover is the location for the Internal Revenue Service facility which has capital expenditures in excess of $10 million in the six year period examined for determining the aggregate amount of capital expenditures by a principal user in a municipality. The U.S. government will be a principal user because a portion of the project will be used for a U.S. Post Office. The anticipated $2.6 million bond issue for the rehabilitation of the town hall, when aggregated with the capital expenditures by the federal government with respect to the IRS service center, would exceed the $10 million limit and thus would disqualify the bonds from tax exempt status.

The technical correction is necessary to exempt the $2.6 million bond issuance by the Town of Andover. The technical correction will not result in a revenue loss to the government but will merely enable the Town to accomplish what was originally intended.

A specific exception to the statewide volume cap limitation is also necessary to insure the availability of funding.

The following technical correction is proposed with the new language underlined.

Proposed Amendment to Section 1317 (27)(I) of the Tax Reform Act of 1986:

> (I) A facility is described in this subparagraph if it consists of the rehabilitation of the Andover Town Hall in Andover, Massachusetts. The provisions of Sections 144(a) and 146 (relating to qualified small issue bonds and volume cap respectively) shall not apply to obligations to finance such project for any purpose. The provisions of 149(b) of the 1986 Code (relating to federally guaranteed obligations) shall not apply to obligations to finance such projects solely as a result of the occupation of a portion of such building by the United States Post Office.

LES ASPIN
1ST DISTRICT, WISCONSIN

CHAIRMAN,
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July 13, 1987

The Honorable Dan Rostenkowski
Chairman,
House Ways & Means Committee
1101 Longworth HOB
Washington, D.C. 20515

Dear Mr. Chairman:

Earlier this year, I sought your assistance in obtaining clarification of the transition rule for the City of Kenosha Downtown Redevelopment Project. As you may recall, in 1974 the Army Corps of Engineers entered into a contract with Kenosha to fill the Confined Disposal Facility (CDF) by 1984. The 32-acre fill site was intended to be the foundation of a comprehensive redevelopment project, consisting of housing, commercial and marina development which will expand and diversify Kenosha's economy. The site, however, remains under water because the Corps has not lived up to its contractual obligation to fill the CDF. (The Corps and the City have recently entered into a settlement agreement whereby the CDF will be filled by September 3, 1996.) Kenosha was unable to take advantage of the incentives contained in the tax code prior to enactment of the Tax Reform Act because assurance of completion of the CDF was essential to persuading developers to go forward with the redevelopment project. Consequently, I sought a transition rule to extend to Kenosha 1984 tax treatment that would have been otherwise available to the city had the Corps completed its work on time. Unfortunately, neither the transition rule nor the proposed technical correction bill will permit Kenosha to go forward with its project.

For these reasons, I request your approval for further amendments to the technical corrections bill:

1) To make September 3, 1996 the date by which the Kenosha Project bonds must be issued in order to qualify for its bond transition rule (this is the date by which the CDF is expected to be completely filled); and

2) To make the 1986 Tax Reform Act's new arbitrage rules and rebate requirements and disincentives to bank purchases inapplicable to Kenosha Project bonds issued no later than September 3, 1996, or if earlier, 27 months (the time period between April 4, 1984 and July 17, 1986) after enactment of the Technical Corrections Act (this extension simply gives Kenosha the same opportunity all taxpayers and municipalities had to get existing and planned projects in line to qualify for pre-1986 Tax Reform Act treatment--an opportunity to date denied Kenosha by the Federal Government); and

3) To make September 3, 1999 the date by which real and personal property comprising the Kenosha Project must be placed in service in order to qualify for its ACRS/ITC Transition Rule (this date is consistent with pre-1986 Treasury Act arbitrage regulations and is three years after the term of the Corps' Kenosha Harbor CDF is over).

4) Finally, since the Kenosha Project is a multi-component project with private sector investments expected to exceed $105,000,000, and the Project's ITC/ACRS Transition Rule and Bond Transition Rule have always been separate and distinct, the phrase "and which is financed with the proceeds of bonds issued pursuant to Section 1317 (6) (W)" needs to be deleted from the substitute Paragraph (M) contained in Section 102(d) (20) (F) of the Technical Corrections Act. If this clause remains in the Technical Corrections Act, the ACRS/ITC Transition Rule for the Kenosha Project is unusable.

I wish to reiterate that the City of Kenosha does not seek special treatment here. Had the federal government, through the Corps of Engineers, fulfilled its contractual agreement to fill the CDF by 1984, this request would not be necessary. Indeed, the entire project would have been well underway utilizing the incentives available prior to enactment of the Tax Reform Act of 1986. Kenosha is seeking only to put the its Downtown Redevelopment Project in the same tax position it would have been in had the Army Corps of Engineers lived up to its contract.

Sincerely,

Les Aspin
Member of Congress

LA/mn

LES ASPIN
1st District, Wisconsin

Chairman,
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August 14, 1987

Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
1102 Longworth Building
Washington, D.C. 20515

Dear Dan:

Thanks for meeting with me and the Kenosha representatives on July 30 to discuss Kenosha technical corrections. We very much appreciated your time and consideration in this matter. As you requested, I'm now enclosing a copy of the General Accounting Office (GAO) report entitled "Legislation Needed to Extend the Life of Confined Disposal Facilities," which deals with the Kenosha Confined Disposal Facility (CDF). I believe you'll see how the GAO report shows that the Army Corps of Engineers put the city of Kenosha in the position they are in now. The Corps knew very early during the initial 10-year fill-in period that it wouldn't be able to live up to its contractual agreement with Kenosha. Unfortunately, Kenosha was unaware that the Corps would be unable to fulfill its contractual obligation.

As you'll notice in the GAO's conclusions on page 4, the GAO felt that Section 123 of P.L.91-611 did "not authorize the Corps [of Engineers] to continue using the Kenosha facility or any other Great Lakes confined disposal facility beyond the 10-year period." This established the fact that the Corps shouldn't have expected to use the CDF after the 10-year period, and should have completed its work by 1984, allowing Kenosha to take advantage of then-available tax legislation.

The GAO report again backs up this claim on page 47 by stating that "the legislative history clearly shows that the Congress wanted to limit the life of disposal facilities to 10 years."

With the 10-year limit on the CDF in mind, I'd now like to present evidence that shows the Corps knew before it started using the Kenosha CDF that the fill-in would take more than 10 years, despite the fact that Congress wanted to limit the Corps' use of the facilities to 10 years. I've obtained a summary of Corps documents dating back to the early 1970's which substantiates this claim. Quotes from Corps documents demonstrate that the Corps was well aware that commercial traffic in Racine and Kenosha harbors was declining, that the CDF dimensions might be too large, and that it could take twice as long (i.e., twenty years) to fill the CDF. The documents also make it clear that the Corps believed it was only entitled to use the facility for 10 years.

The following are quotes taken from a summary of a Corps document entitled "Final Environmental Impact Statement". The summary document is also attached, with the key areas marked.

The Corps concurred in a comment submitted by the Wisconsin Wildlife Federation, which stated as follows:

> We believe that the importance of Racine and Kenosha as deep draft ports will decline in the next ten years, while the use of the harbor for recreational and water sports will increase. Thus what is now planned for a ten-year project may in fact be extended to twice that amount...

Quote directly from Final Environmental Impact Statement:

> There is considerable speculation over the future of Kenosha and Racine harbors. Both harbors have become more recreational in character over the years...Anticipating a reestablishment of priorities would make it appropriate to incorporate contingency measures into the dredge spoil containment policy at Kenosha harbor. If, for example, less material needs to be dredged than originally estimated, it might be appropriate to fill the disposal area in a segmented manner...

The Corps also concurred in this comment from the Environmental Protection Agency:

> ...Since the future use of Kenosha Harbor is undecided, we believe that the EIS should discuss the possible consequences of committing this site for a disposal area. If the future use of the harbor will not necessitate the dredging of 350,000 cubic yards, the capacity of the proposed dike disposal area will be too large..."

From a Corps memorandum dated Aug. 7, 1980:

> In view of the limited amount of existing and projected deep-draft commerce, it does not appear that maintenance dredging will be economically justified at Racine harbor in the foreseeable future.

The following quote from a Corps document dated March 20, 1974, proves a related argument that the Corps was well aware of the city's plan to develop the CDF site for a recreational area:

> ...at the end of its ten-year fill life, the site will be developed into a public recreation area.

From a Corps memorandum dated August 27, 1973:

> In each instance...where a contained disposal area is planned along the Great Lakes, the operational life of such an area is limited to ten years.

As you can see from the above citations, the Corps realized from the beginning that it wouldn't be able to fill in the Kenosha CDF by the scheduled time of 1984, and that by failing to keep to the contractual obligation, Kenosha would be left with an unfilled CDF for much longer than the originally intended 10 years.

It is for these reasons that I'm now asking you to help out by extending tax benefits to cover Kenosha's $105 million in bonding authority. As you know, these were curtailed by the 1986 Tax Reform Act. By not completing its work on time, the Corps put Kenosha in the situation it is today. The Corps' inaction prevented Kenosha from taking advantage of tax incentives available from 1984-1986. I would simply like for you to put Kenosha in the position it should have been in had the Corps lived up to its contractual agreement.

Thanks for your time and consideration.

Sincerely,

Les Aspin
Member of Congress

CHESTER G. ATKINS
5TH DISTRICT, MASSACHUSETTS

COMMITTEES
BUDGET
EDUCATION AND LABOR
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STANDARDS OF OFFICIAL CONDUCT

LINDA J. HARTKE
ADMINISTRATIVE ASSISTANT

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July 17, 1987

Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Rostenkowski:

I am writing in support of a request by the Town of Andover, Massachusetts that a technical correction to the transition rule in Section 1317(27)(I) of the Tax Reform Act, which assists Andover in obtaining tax-exempt financing for the restoration of their historic Town Hall, be slightly modified.

The original transition rule states that the bond provisions relating to federally guaranteed obligations would not apply to obligations to finance the Andover project because a portion of the building will be leased to the United States Post Office. The transition rule was necessary because the United States Post Office, as a United States government agency, could not be a tenant of the building if tax-exempt financing was utilized under the present Internal Revenue Service Code provisions. The rehabilitated Town Hall will retain its integrity, design and use as a Post Office and Municipal building. The Post Office, which was one of the original tenants when the building was constructed in 1858, will have a service center in the renovated Town Hall.

It was subsequently determined and confirmed with the IRS that capital expenditure limitations for qualified small issue bonds could possibly preclude the issuance of tax-exempt bonds for this project. Under the present IRS guidelines, the aggregate capital expenditures of a principal user, in this case the federal government, in one municipality cannot exceed $10 million in a six-year period, beginning three years before the bond issue.

Andover is the site of the Northeast Regional Service Center for the IRS, which has capital expenditures in excess of the $10 million over six years proscribed by the rule. As such, a technical correction was requested to exclude the application of the qualified small issue bond limitations to obligations to finance the Andover Town Hall project. The actual language of the technical correction, Section 113 (g)(27) of HR 2636, explicitly exempts the project from application of the rules "with respect to any internal revenue service center."

However, capital expenditure in other Andover facilities used by the federal government may exceed the $40 million limitation imposed on all other tax-exempt bonds issued to finance other facilities owned or used by the same principal user, in this case the federal government [Code Section 144(a)(10)]. Thus, the technical correction needs to be modified slightly to insure that the bonds issued for the Andover project will remain tax-exempt.

The technical correction will not result in any lost revenue; it will only insure the tax-exempt financing. I would greatly appreciate your support for the amendment described in the enclosed summary. With warm regards, I remain,

Sincerely yours,

Chet Atkins

Chester G. Atkins
Member of Congress

SUMMARY OF PROPOSED TECHNICAL CORRECTION OF SECTION 1317 (27)(I) OF THE TAX REFORM ACT OF 1986 FOR THE TAX EXEMPT FOR THE TOWN HALL OF ANDOVER, MASSACHUSETTS

The Town of Andover, Massachusetts received a transition rule under Section 1317(27)(I) from the Tax Reform Act of 1986 to assist in the restoration and rehabilitation of the Andover Town Hall built in 1858.

The transition rule provided for an exemption from Section 149(b) of the 1986 Code relating to federally guaranteed obligations but did not exempt the project from Section 144 regarding the $10 million capital expenditure limitation for small issue bonds in a municipality by a "principal user". The Town of Andover is the location for the Internal Revenue Regional Service facility which has capital expenditures in excess of $10 million in the six year period examined for determining the aggregate amount of capital expenditures by a principal user in a municipality. The U.S. government will be a principal user because a portion of the project will be used for a U.S. Post Office. The anticipated $2.6 million bond issue for the rehabilitation of the Town Hall, when aggregated with the capital expenditures by the federal government with respect to the IRS service center and possible other federal facilities, would exceed the $10 million limit and thus would disqualify the bonds from tax exempt status. Although a technical correction was proposed in Section 113(g)(27) of H.R. 2636 to exclude the Internal Revenue Service facility, other federal facilities may have capital expenditures or other tax exempt facility-related bonds allocable to the United States Government which may affect the tax exempt status.

The technical correction is necessary to exempt the $2.6 million bond issuance by the Town of Andover. The technical correction will not result in a revenue loss to the government but will merely enable the Town to accomplish what was originally intended.

The following technical correction is proposed with the new language underlined.

Proposed Amendment to Section 113(g)(27) of the H.R. 2636:

> (27) Subparagraph (I) of section 1317(27) of the Reform Act is amended by adding at the end thereof the following: "For purposes of determining whether any bond to which this subparagraph applies is a qualified small issue bond, there shall not be taken into account under section 144(a) of the 1986 Code capital expenditures with respect to any ~~internal revenue service center~~ facilities of the United States government and all other tax exempt facility-related bonds allocable to the United States government."

June 25, 1987

Comments on the Technical Corrections Act of 1987

Comments on HR-2636 The Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986 and provisions within it allowing for the issuance of Tax Exempt Bonds on behalf of a university founded in 1789.

Present text-page 414 (lines 9-25) page 415 (lines 1-3)

(33) Subparagraph (H) of section 1317(33) of the reform act is amended--

> **(A) by striking out clause (ii) and inserting in lieu thereof the following:**
>
> "(ii) the proceeds of the issue are to be used to finance projects (to be determined by such university and the issuer) which are similar to those projects intended to be financed by bonds that were the subject of a request transmitted to Congress on November 7, 1985, and", and
>
> (B) by adding at the end thereof the following new sentence: "Bonds to which this subparagraph applies shall be treated as qualified 501(c)(3) bonds if such bonds would not (if issued on August 15, 1986) be industrial development bonds (as defined in section 103(b)(2) of the 1954 Code), and section 147(f) of the 1986 code shall not apply to the issue of which such bonds are a part."

For the purpose of clarification, this section (33) should be changed to read as follows:

(33)

> (a) Subparagraph (H) of section 1317(33) of Public Law 99-514 is amended by striking out clauses (i) and (ii) and inserting in lieu thereof the following:
>
> "(i) the issue is issued by a university founded in 1789 and incorporated under the laws of the United States in 1815 (or for the benefit of such a university by a state or local government),
>
> "(ii) the proceeds of such an issue are to be used to finance projects which are similar to those projects intended to be financed by bonds which were the subject of a request transmitted to Congress on November 7, 1985,
>
> "(iii) no bond issued as part of such issue would have been an industrial development bond (as defined in section 103(b)(2) of the 1954 Code) if issued before August 16, 1986, and
>
> "(iv) such an issue meets the requirement of section 145(a)(1) of the 1986 Code."
>
> (b) Subparagraph (H) of section 1317(33) of Public Law 99-514 is amended by adding at the end thereof the following: "Bonds issued as part of an issue to which this subparagraph applies shall be treated for purpose of the 1986 Code as qualified 501(c)(3) bonds (as defined in section 145 of such Code) issued by a State and section 147(f) of Code shall not apply to such bonds."

(The above language was prepared by a joint committee staff member at the direction of the Chairman of the Ways and Means Committee.)

Explanation

The present language permits a certain university to issue tax exempt bonds in the amount of 200 million dollars either through the jurisdiction in which it is located or through a jurisdiction outside its location.

Because of an unrelated court case, this university and the jurisdiction in which it is located are prevented from the issuance of the bonds. The court case does not appear to be resolvable in the foreseeable future.

The University has found that the two appropriate neighboring jurisdictions , that the present language would allow, will not issue the tax exempt bonds.

The above information has been presented in detail to the Chairman and Ranking member of the Ways and Means Committee.

For this reason the clarification language was proposed to the Senate Finance Committee Chairman in the first meeting by the Chairman of the the Ways and Means Committee.

In addition a petition was made by a Senator, who is a member of the Senate Finance Committee, in a May 22, 1987, letter to the Chairman of the Senate Finance Committee:

> "For several years, a "University founded in 1789" has attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.
>
> Because this university had made plans based on prior law, Congress included a transition rule in the Tax Reform Act of 1986, allowing the university to rely on prior law with respect to the treatment of the tax exempt bonds. Although this rule was included in the tax reform bill, a clarification was provided in the concurrent resolution accompanying the tax bill to permit the university greater latitude in having the bonds issued. Unfortunately, a further modification of the transitional rule is now necessary because, in spite of Congressional intent to the contrary, it appears that this university will be indefinitely foreclosed from having bonds issued on their behalf.
>
> I believe this is a reasonable request and consistent with the ground rules you have established for the Technical Corrections legislation. Congress intended in the tax reform bill to permit up to $200 million of the bonds to be issued for this university. The cost of these bonds was calculated in the revenue estimates of the bill and the requested modification would only serve to enable this university to do what Congress had originally proposed. It is necessary that the technical amendment permit the university to serve as the issuer of the bonds. While I realize this is unusual, I understand it to be consistent with other transition rules in the Tax Reform Act which permit certain state-related, private universities to issue tax exempt bonds."

The response of the Chairman of the Senate Finance Committee to the Senator on May 28, 1987, states:

> "I understand that "the particular university" has been unable to issue tax exempt bonds under the transition rule because of a legal dispute in the District of Columbia. It is unfortunate that a six year old court case is delaying the issuance of "the particular university's" bonds.
>
> The issue of this "particular university" has been seriously discussed on a number of occasions in the preparation of that bill. Unfortunately, under the very strict definition of technical correction which we have utilized in sifting through the myriad of requests, it does not appear that the change requested by "this university" will qualify. Nevertheless, this is certainly an issue that can be discussed in the Finance Committee when we meet to consider technical corrections."

In a letter of June 18, 1987, a Republican Senator of the Senate Finance Committee made a similar petition to the Ranking Member:

> **For several years, a particular university attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.**
>
> **You may recall that last year in recognition of the unique problems facing this university transition relief was provided to permit up to $200 million of bonds to be issued. An interested Senator's amendment which would provide issuing authority to the university is necessary to allow this university to proceed.**
>
> I hope we will be able to resolve this problem during committee consideration."

In Summary:

The present Tax Reform Act of 1986 has a provision allowing the particular university to issue tax exempt bonds in the amount of 200 million dollars for projects completed or underway through the jurisdiction in which the university resides, and with bonds approved by that jurisdiction. This authority was signed into law. Prior to the signing into law, the particular university notified the House Ways and Means Committee and the Senate Finance Committee of the inability to proceed because of an unrelated court case affecting the governmental authority and the university .

A modification was made to the transition rule allowing the university to seek relief in adjacent jurisdictions. Since that time, the University has petitioned the two adjacent jurisdictions to get appropriate steps accomplished. Both jurisdictions were unable to accommodate the request.

The intent of the Congress included consideration of the cost of the 200 million in tax exempt bonds in permitting the transition rule. It is necessary to permit the University to issue tax exempt bonds itself. There is a similar provision for certain universities in the present transition rule.

In accordance with instructions in Press Release #12, Wed. June 10, 1987, the copies of whole documents are attached separately so that they will be maintained in the Committee files for review and use by the Committee.

Submitted by:

T. Byron Collins, S.J.

Samuel Harvey, Jr.

Assistants to the President
Georgetown University
Washington, D.C.

HOWARD UNIVERSITY
WASHINGTON, D. C. 20059

OFFICE OF THE VICE PRESIDENT
FOR DEVELOPMENT AND
UNIVERSITY RELATIONS

July 10, 1987

Dear Mr. Leonard:

We are writing to request certain corrections with respect to the Technical Corrections Bill of 1987 (H.R. 2636). First, we request that the $112 million issue authorized by the Howard University Revenue Bond Act of 1986, District of Columbia Law 6-156, be excepted from the $150 million limitation provided in subparagraph (K) of Section 1317 (33) of the Tax Reform Act of 1986. The housing facility to be financed by this issue is intended to provide accommodations for some Howard University Hospital staff and thus an exclusion of all or a portion of this issue is consistent with the exclusion of hospital issues from the $150 million limitation.

Second, by way of a technical correction, we request that the "900 units" in clause (i) of the above-referenced provision of the Tax Reform Act be changed to "up to 1200 units" in order to conform with the project size stated in the Howard University Bond Act of 1986.

Finally, we would like to express our appreciation for the technical corrections already included in H.R. 2636, specifically those allowing more than one issue, correcting the square footage of the proposed office building, and correcting the dollar amount of the 1986 issue.

Sincerely yours,

Roger D. Estep

Roger D. Estep, D. V. M.
Vice President for Development
and University Relations

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515-6348

DELBERT L. LATTA
5TH DISTRICT, OHIO

COMMITTEES:
RULES
BUDGET

Congress of the United States
House of Representatives
Washington, DC 20515

July 15, 1987

The Honorable Dan Rostenkowski, Chairman
House Committee on Ways and Means
Room 1102, Longworth H. O. B.
Washington, D. C. 20515

Dear Mr. Chairman:

Pursuant to your instructions, I am herewith filing a technical correction amendment to an amendment which was made in the Tax Reform Act of 1986. This amendment corrects the section number and clarifies the language which was included in the Tax Reform Act for the sale of bonds by Bowling Green, Ohio, for a coal gasification project to produce electricity for the city.

The inclusion of this amendment in the technical correction bill will be appreciated.

With my best personal wishes, I am

Sincerely yours,

DELBERT L. LATTA
Representative to Congress

Sec. ________ Amendments Related to Section 1317 of the Tax Reform Act of 1986

(a) Clarification of Transitional Rule for Certain Pollution Control Facilities. Section 1317(2) of the Tax Reform Act of 1986 (relating to certain pollution control facilities) is amended:

(1) by deleting "103(b)(4)([illegible]" and inserting in lieu thereof "103(b)(4)(F)", and

(2) by adding the following new sentence at the end thereof "A facility described in subparagraph (L) that removes elements or compounds from coal which upon burning or combustion would otherwise be released as atmospheric contaminants or pollutants shall be treated as an air or water pollution control facility and shall be treated as having no function or purpose other than the control of pollution, for purposes of §103(b)(4)(F) of the 1954 Code (and this section)".

SEC. 1317. TRANSITIONAL RULES FOR SPECIFIC FACILITIES.

(1) DOCKS AND WHARVES.—A bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide any dock or wharf (within the meaning of section 103(b)(4)(D) of the 1954 Code) shall be treated as an exempt facility bond (for a facility described in section 142(a)(2) of the 1986 Code) for purposes of part IV of subchapter B of chapter 1 of the 1986 Code if such dock or wharf is described in any of the following subparagraphs:

(A) A dock or wharf is described in this subparagraph if—

(i) the issue to finance such dock or wharf was approved by official city action on September 3, 1985, and by voters on November 5, 1985, and

(ii) such dock or wharf is for a slack water harbor with respect to which a Corps of Engineers grant of approximately $2,000,000 has been made under section 107 of the Rivers and Harbors Act.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $2,500,000.

(B) A dock or wharf is described in this subparagraph if—

(i) inducement resolutions were adopted on May 23, 1985, September 18, 1985, and September 24, 1985, for the issuance of the bonds to finance such dock or wharf,

(ii) a harbor dredging contract with respect thereto was entered into on August 2, 1985, and

(iii) a construction management and joint venture agreement with respect thereto was entered into on October 1, 1984.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $625,000,000.

(C) A facility is described in this subparagraph if—

(i) the legislature first authorized on June 29, 1981, the State agency issuing the bond to issue at least $30,000,000 of bonds,

(ii) the developer of the facility was selected on April 26, 1985, and

(iii) an inducement resolution for the issuance of such issue was adopted on October 9, 1985.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $200,000,000.

(D) A facility is described in this subparagraph if—

(i) an inducement resolution was adopted on October 17, 1985, for such issue, and

(ii) the city council for the city in which the facility is to be located approved on July 30, 1985, an application for an urban development action grant with respect to such facility.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $36,500,000. A facility shall be treated as described in this subparagraph if it would be so described if "90 percent" were substituted for "95 per-

cent" in the material preceding subparagraph (A) of this paragraph.

(2) POLLUTION CONTROL FACILITIES.—A bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide air or water pollution control facilities (within the meaning of section 103(b)(4)(C) of the 1954 Code) shall be treated as an exempt facility bond for purposes of part IV of subchapter B of chapter 1 of the 1986 Code if such facility is described in any of the following subparagraphs:

(A) A facility is described in this subparagraph if—

(i) inducement resolutions with respect to such facility were adopted on September 23, 1974, and on April 5, 1985,

(ii) a bond resolution for such facility was adopted on September 6, 1985, and

(iii) the issuance of the bonds to finance such facility was delayed by action of the Securities and Exchange Commission (file number 70-7127).

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $120,000,000.

(B) A facility is described in this subparagraph if—

(i) there was an inducement resolution for such facility on November 19, 1985, and

(ii) design and engineering studies for such facility were completed in March of 1985.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $25,000,000.

(C) A facility is described in this subparagraph if—

(i) a resolution was adopted by the county board of supervisors pertaining to an issuance of bonds with respect to such facility on April 10, 1974, and

(ii) such facility was placed in service on June 12, 1985.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $90,000,000. For purposes of this subparagraph, a pollution control facility includes a sewage or solid waste disposal facility (within the meaning of section 103(b)(4)(E) of the 1954 Code).

(D) A facility is described in this subparagraph if—

(i) the issuance of the bonds for such facility was approved by a State agency on August 22, 1979, and

(ii) the authority to issue such bonds was scheduled to expire (under terms of the State approval) on August 22, 1989.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $198,000,000.

(E) A facility is described in this subparagraph if—

(i) such facility is 1 of 4 such facilities in 4 States with respect to which the Ball Corporation transmitted a letter of intent to purchase such facilities on February 26, 1986, and

(ii) inducement resolutions were issued on December 30, 1985, January 15, 1986, January 22, 1986, and

March 17, 1986 with respect to bond issuance in the 4 respective States.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $6,000,000.

(F) A facility is described in this subparagraph if—

(i) inducement resolutions for bonds with respect to such facility were adopted on September 27, 1977, May 27, 1980, and October 8, 1981, and

(ii) such facility is located at a geothermal power complex owned and operated by a single investor-owned utility.

For purposes of this subparagraph and section 103 of the 1986 Code, all hydrogen sulfide air and water pollution control equipment, together with functionally related and subordinate equipment and structures, located or to be located at such power complex shall be treated as a single pollution control facility. The aggregate face amount of bonds to which this subparagraph applies shall not exceed $600,000,000.

(G) A facility is described in this subparagraph if—

(i) such facility is an air pollution control facility approved by a State bureau of pollution control on July 10, 1986, and by a State board of economic development on July 17, 1986, and

(ii) on August 15, 1986, the State bond attorney gave notice to the clerk to initiate validation proceedings with respect to such issue and on August 28, 1986, the validation decree was entered.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $900,000.

(I) A facility is described in this subparagraph if—

(i) a private company met with a State air control board on November 14, 1985, to propose construction of a sulften unit, and

(ii) the sulften unit is being constructed under a letter of intent to construct which was signed on April 8, 1986.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $11,000,000.

(J) A facility is described in this subparagraph if it is part of a 250 megawatt coal-fired electric plant in northeastern Nevada on which the Sierra Pacific Power Company began construction in 1980. The aggregate face amount of bonds to which this subparagraph applies shall not exceed $200,000,000.

(K) A facility is described in this subparagraph if—

(i) there was an inducement resolution adopted by a State industrial development authority on January 14, 1976, and

(ii) such facility is named in a resolution of such authority relating to carryforward of the State's unused 1985 private activity bond limit passed by such industrial development authority on December 18, 1985.

This subparagraph shall apply only to obligations issued at the request of the party pursuant to whose request the January 14, 1976, inducement was given. The aggregate face amount of bonds to which this subparagraph applies shall not exceed $75,000,000.

(L) A facility is described in this subparagraph if a city council passed an ordinance (ordinance number 4626) agreeing to issue bonds for such project December 16, 1985. The aggregate face amount of obligations to which this subparagraph applies shall not exceed $45,000,000.

(3) SPORTS FACILITIES.—A bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide sports facilities (within the meaning of section 103(b)(4)(B) of the 1954 Code) shall be treated as an exempt facility bond for purposes of part IV of subchapter B of chapter 1 of the 1986 Code if such facilities are described in any of the following subparagraphs:

(A) A facility is described in this subparagraph if it is a domed stadium—

(i) which was the subject of a city ordinance passed on September 23, 1985,

(ii) for which a loan of approximately $4,000,000 for land acquisition was approved on October 28, 1985, by the State Controlling Board, and

(iii) a stadium operating corporation with respect to which was incorporated on March 20, 1985.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $200,000,000.

(B) A facility is described in this subparagraph if—

(i) it is a stadium with respect to which a lease agreement for the ground on which the stadium is to be built was entered into between a county and the stadium corporation for such stadium on July 3, 1984,

(ii) there was a resolution approved on November 14, 1984, by an industrial development authority setting forth the terms under which the bonds to be issued to finance such stadium would be issued, and

(iii) there was an agreement for consultant and engineering services for such stadium entered into on September 28, 1984.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $90,000,000.

(C) A facility is described in this subparagraph if—

(i) it is a stadium to be used by an American League baseball team currently using a stadium in a city having a population in excess of 2,500,000 and described in section 146(d)(3) of the 1986 Code, or by one or more professional sports teams currently using stadiums in such city (or professional sports teams which locate in such city following the relocation from such city of one or more professional sports teams currently using one or more of such stadiums), and

(ii) the obligations to be used to provide financing for such stadium are issued pursuant to an inducement

Congreſs of the United States
Washington, DC 20515

July 13, 1987

The Honorable Dan Rostenkowski
Chairman,
House Ways & Means Committee
1101 Longworth HOB
Washington, D.C. 20515

Dear Mr. Chairman:

Earlier this year, we sought your assistance in obtaining clarification of the transition rule for the City of Kenosha Downtown Redevelopment Project. As you may recall, in 1974 the Army Corps of Engineers entered into a contract with Kenosha to fill the Confined Disposal Facility (CDF) by 1984. The 32-acre fill site was intended to be the foundation of a comprehensive redevelopment project, consisting of housing, commercial and marina development which will expand and diversify Kenosha's economy. The site, however, remains under water because the Corps has not lived up to its contractual obligation to fill the CDF. (The Corps and the City have recently entered into a settlement agreement whereby the CDF will be filled by September 3, 1996.) Kenosha was unable to take advantage of the incentives contained in the tax code prior to enactment of the Tax Reform Act because assurance of completion of the CDF was essential to persuading developers to go forward with the redevelopment project. Consequently, Congressman Aspin sought a transition rule to extend to Kenosha 1984 tax treatment that would have been otherwise available to the city had the Corps completed its work on time. Unfortunately, neither the transition rule nor the proposed technical correction bill will permit Kenosha to go forward with its project.

For these reasons, we request your approval for further amendments to the technical corrections bill:

1) To make September 3, 1996 the date by which the Kenosha Project bonds must be issued in order to qualify for its bond transition rule (this is the date by which the CDF is expected to be completely filled); and

2) To make the 1986 Tax Reform Act's new arbitrage rules and rebate requirements and disincentives to bank purchases inapplicable to Kenosha Project bonds issued no later than September 3, 1996, or if earlier, 27 months (the time period between April 4, 1984 and July 17, 1986) after enactment of the Technical Corrections Act (this extension simply gives Kenosha the same opportunity all taxpayers and municipalities had to get existing and planned projects in line to qualify for pre-1986 Tax Reform Act treatment--an opportunity to date denied Kenosha by the Federal Government); and

3) To make September 3, 1999 the date by which real and personal property comprising the Kenosha Project must be placed in service in order to qualify for its ACRS/ITC Transition Rule (this date is consistent with pre-1986 Treasury Act arbitrage regulations and is three years after the term of the Corps' Kenosha Harbor CDF is over).

4) Finally, since the Kenosha Project is a multi-component project with private sector investments expected to exceed $105,000,000, and the Project's ITC/ACRS Transition Rule and Bond Transition Rule have always been separate and distinct, the phrase "and which is financed with the proceeds of bonds issued pursuant to Section 1317 (6) (W)" needs to be deleted from the substitute Paragraph (M) contained in Section 102(d) (20) (F) of the Technical Corrections Act. If this clause remains in the Technical Corrections Act, the ACRS/ITC Transition Rule for the Kenosha Project is unusable.

We would like to reiterate that had the Corps of Engineers fulfilled its contractual agreement to fill the CDF by 1984, this request would not be necessary. Indeed, the entire project would have been well underway utilizing the incentives available prior to enactment of the Tax Reform Act of 1986. We are seeking only to put the Kenosha Downtown Redevelopment Project in the same tax position it would have been in had the Federal Government, through the Army Corps of Engineers, lived up to its contract.

Sincerely,

Jim Moody
Jim Moody

Bob
Bob Matsui

Tom Downey

SID MORRISON
4TH DISTRICT, WASHINGTON

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Congress of the United States
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Washington, DC 20515

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July 17, 1987

The Honorable Dan Rostenkowski
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is in response to your call for comments on H.R. 2636, the technical corrections bill to the Tax Reform Act of 1986.

First, let me thank you for your special efforts to permit both current and advance refunding, up to $2 billion, for bonds on Washington Public Power Supply System's nuclear plants 1 and 3. This is a particular benefit to electric ratepayers of the Northwest and California who are served by the Bonneville Power Administration, which is paying debt service on these two plants. It is also a benefit for the federal government since the refunding would eliminate substantial amounts of currently outstanding tax-exempt interest.

There are two issues that could make this an even better opportunity. Under the provisions of the technical corrections bill new bonds would have to be sold before 1992. Only the earliest of four installments on $1.6 billion in bonds could be refinanced under this provision. Removal of this deadline would benefit the federal government and the Northwest ratepayers. Your staff has been provided information on the revenue impact of such an adjustment. I think you will find it a reasonable option.

The technical corrections bill also precludes advance refunding on the Supply System's operating No. 2 plant. The highest benefit can be achieved if advance refunding is permitted on all three plants up to $2 billion and if current refunding (which saves the federal government revenue) is permitted without dollar limits.

I hope you will take these issues into consideration as we complete the fine tuning of the Tax Reform Act.

Sincerely,

Sid

Sid Morrison

THE NEW YORK HOSPITAL
Chartered 1771
525 EAST SIXTY-EIGHTH STREET
NEW YORK, N.Y., 10021

July 17, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of The Society of the New York Hospital (the "Hospital"), I would like to thank the Committee for including in section 113(g) of the Technical Corrections Act of 1987, H.R. 2636, a corrected version of the transition rule originally granted the Hospital by section 202 of H. Con. Res. 395. I would also like to express my appreciation for this opportunity to explain the Hospital's request that additional language be included in the transition rule to clarify that the Hospital may fully utilize the relief earmarked for it in that rule to complete its modernization program. This supplemental language would not increase the revenue impact of the transition rule as granted in H.R. 2636.

The transition rule provides that $150 million of nonhospital bonds to be issued for the Hospital's benefit will be exempt from the nonhospital bond volume limitation enacted under the Tax Reform Act of 1986. While the rule, as currently drafted, mentions certain Hospital projects to which the bond proceeds may be applied, it does not expressly refer to the most significant project undertaken by the Hospital: the modernization of its 50-year-old plant. That project, which has been actively planned since 1982, is critical to the Hospital's ability to maintain the highest standards of medical care.

The primary focus of the modernization plan is the renovation of the Hospital's inpatient facilities. Since bonds used to finance such facilities are "qualified hospital bonds" which are not subject to the volume restrictions, transitional relief is not needed in order to finance this principal aspect of the modernization plan. However, an integral part of the modernization project is the renovation of such facilities as the Hospital's research laboratories and medical education and ambulatory care facilities, which are equally critical to the Hospital's ability to provide high-quality medical care. Indeed, certain aspects of the inpatient facility modernization, such as the required expansion of the electrical power generating capacity, cannot be implemented without affecting these "nonhospital" facilities. To the extent the modernization project involves such facilities, financing for the project is subject to the nonhospital bond volume cap. In order to clarify that the $150 million of transitional relief already earmarked for the Hospital may be applied to finance the essential modernization of those facilities, we request that the transition rule be supplemented to read as follows (additional language underscored):

> "(M) Proceeds of an issue are described in this subparagraph if such issue is issued on behalf of the Society of the New York Hospital to finance completion of a project commenced by such hospital in 1981 for construction of a diagnostic and treatment center or to refund bonds issued on behalf of such hospital in connection with the construction of such diagnostic and treatment center or to finance construction and renovation projects associated with an inpatient psychiatric care facility or other facilities of such hospital. The aggregate face amount of bonds to which this subparagraph applies shall not exceed $150,000,000."

The change which the Hospital seeks does not expand the scope of relief beyond that granted last fall. Instead, it simply allows the Hospital the necessary flexibility to continue its modernization within the already agreed upon constraints of the $150 million transition rule included in H.R. 2636 and H. Con. Res. 395.

Thank you for your consideration in this matter.

Sincerely yours,

John P. Glynn

John P. Glynn
Executive Associate Director
Financial Services

ARTHUR RAVENEL, JR.
1st District, South Carolina

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ARMED SERVICES

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August 7, 1987

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Building
Washington, D.C. 20515

Dear Chairman Rostenkowski,

On May 20, 1986 New Orleans Cold Storage South Atlantic Cold Storage and Warehouse, Inc. ("South Atlantic") entered into an irrevocable agreement with the South Carolina State Port Authority to construct and operate a cold storage warehouse facility for the Port of Charleston. South Atlantic had begun operating the state's refrigeration facility on January 15, 1986. The State supported the construction of this new privately-owned modern facility in order to attract additional vessels to the Port of Charleston, thereby providing additional revenues for the city of Charleston of between $50,000 to $60,000 per day per additional freighter. Ships ordinarily dock and unload at one location on the eastern seaboard based on a port's refrigerated container storage capacity because refrigerated cargo is the most perishable.

A $4 million industrial development bond was issued by the State Port Authority for purposes of defraying part of the large intitial construction costs for the facility. However, because last year's Tax Reform Act eliminated the deductibility of interest paid to depositors by the institutional purchaser of such a bond, the bank holding the bond has raised the interest rate charged to the borrower by 3 to 4 percent. This in turn will force South Atlantic to raise cargo rates and to become uncompetitive with other ports, thereby threatening Charleston's shipping income and the economics of a transaction that was set in place long before the enactment of tax reform legislation.

We therefore request the inclusion of a technical correction to a transition rule already included in the Tax Reform Act for the benefit of South Atlantic and the citizens of South Carolina. Such a provision should retain prior law for institutional purchasers of tax-exempt bonds issued for the South Atlantic warehouse project, thereby enabling them to continue to deduct 80 percent of the interest paid to depositors which is allocable to those tax-exempt obligations. South Atlantic and the state of

South Carolina relied on prior law in entering into the cold storage facility transaction. It was mistakenly believed that a transition rule in last year's Act relating to "Charleston, South Carolina waterfront project" would maintain the applicability of prior law to the South Atlantic project. The revenue cost of this clarification would be de minimis, ranging between $520,000 and $1.2 million over the 31-year life of the loan according to detailed analysis by the accounting firm of Ernst & Whinney.

We appreciate your favorable consideration and look forward to working with you and members of the Committee to resolve this matter.

With every good wish,
The South Carolina Delegation

Arthur Ravenel Jr.
Arthur Ravenel, Jr.

Liz Patterson
Elizabeth J. Patterson

Butler Derrick
Butler Derrick

Floyd Spence
Floyd Spence

Robin Tallon
Robin Tallon

John Spratt Jr.
John M. Spratt, Jr.

Title XIV
Comments on more than one section

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Reply to:
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July 16, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Dear Mr. Leonard:

Enclosed are six (6) copies of an individual submission of comments with regard to the generation-skipping transfer tax provsiions of the proposed Technical Corrections Act of 1987.

As the covering memorandum indicates, although this submission was developed by the appropriate committee of the Real Property Probate and Trust Law Section of the American Bar Association, it has undergone no formal review and evaluation process and should be taken as a submission by the named individuals only.

Very truly yours,

P H Schneider

Pam H. Schneider

SUBMISSION TO THE STAFFS OF THE COMMITTEE ON WAYS AND MEANS AND OF THE U.S. HOUSE OF REPRESENTATIVES AND THE COMMITTEE ON FINANCE OF THE U.S. SENATE WITH RESPECT TO THE PROVISIONS OF THE TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636 AND S 1360) CONCERNING THE GENERATION-SKIPPING TRANSFER TAX

Attached are two sets of comments relating to the generation-skipping transfer tax portions of the proposed Technical Corrections Act of 1987. The first set of comments deals with provisions in the Act; the second set deals with additional areas that we believe need to be addressed.

This material is being submitted by the undersigned in their personal and individual capacities. Although each holds officer and/or committee positions in the Real Property Probate and Trust Law Section of the American Bar Association, the materials have not received the approval of the Council of the Real Property Probate and Trust Law Section, nor, of course, of the American Bar Association itself. Therefore, the submission should not be taken as a submission of the American Bar Association or the Real Property Probate and Trust Law Section, but rather the submission of the individuals listed below.

This submission also incorporates the views of various individual members of the Section of Taxation of the American Bar Association. Ronald D. Aucutt, Chair of the Committee on Estate and Gift Taxation of the Section of Taxation advises us that for that reason, those views will not be separately submitted by those members of the Section of Taxation.

We hope you find the attached submission to be of use.

Respectfully submitted,

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Comments Concerning Provisions of the Technical Corrections Act of 1987, S. 1350 and H.R. 2636, and the Joint Committee On Taxation's Description of the Technical Corrections Act of 1987 that Relate to the Generation-Skipping Transfer Tax

1. Taxable Termination Does Not Include Direct Skip.

Section 114(f)(3) of the proposed Technical Corrections Act of 1987 ("TCA-1987") would introduce new section 2612(a)(3) which provides that "the term 'taxable termination' shall not include any transfer which is a direct skip." The provision should be modified so that it is clear that a transfer will not be a taxable termination even if it would not be treated as a direct skip because of the application of the predeceased child exclusion of section 2612(c) or the $2 million per grandchild exclusion of section 1433(b)(3) of the Reform Act. One possible modification would involve deleting the period after the words "direct skip" and adding the following: "or which would have been a direct skip but for the application of section 2612(c)(2) or section 1433(b)(3) of the Tax Reform Act of 1986."

2. Deduction for Transfers for Public, Charitable and Religious Uses.

Section 114(f)(4)(A) of TCA-1987 would add new section 2625 which is designed to provide a generation-skipping transfer tax charitable deduction. Although a charitable deduction does not appear to have any significance in the situation described in The Joint Committee on Taxation's Description of the Technical Corrections Act of 1987 ("Description") it appears to be significant in other contexts.

The example in the Description appears to be incorrect because it ignores the fact that the charity, a non-skip person, would have an interest immediately after the death of the child, so there would not be a taxable termination. This is because a charity is considered to be in the generation of the transferor under the provisions of 2651(e)(3), and a charitable remainderman is considered to have an interest in a charitable remainder trust under section 2652(c)(1).

There are other situations, however, where a charitable deduction is permitted for estate and gift tax purposes but the charity would not be deemed to have an interest for generation-skipping transfer tax purposes. In such circumstances, a generation-skipping transfer tax charitable deduction might be both significant and desirable even if the change that would be made by Section 114(f)(4)(C) of TCA-1987 (discussed as item 3 below) is not made. For example, a transferor could give a life estate in his farm to his grandchild with the remainder passing to charity. The charity would not be deemed to have an interest in the farm and thus, without this deduction, a direct skip tax would have to be paid on the full value of the transfer even though a gift or estate tax charitable deduction would be permitted for the remainder interest.

This generation-skipping transfer tax charitable deduction would also be significant if section 2652(c)(1)(B) is construed to mean that where a particular charity is not specified, no "charity" has an interest in the trust (as for example where the trustee is directed to choose any section 170(c) organization). Consider a trust providing as follows: annuity to child for life then annuity to unspecified charity for 5 years then remainder to grandchild. On son's death, no person would have an interest in the trust so a taxable termination would occur and a charitable deduction would be significant. It is not clear, however, that this is what was intended by the new provision.

3. Use of Charitable Deduction in Computing the Applicable Fraction.

Section 114(f)(4)(C) of TCA-1987 would delete the provision that permits a charitable deduction (if allowed under section 2055 or 2522) in determining the denominator of the applicable fraction. This proposed change goes beyond the scope of technical corrections in that it does considerably more than "correct, clarify or conform" the various provisions of the Tax Reform Act of 1986. It is also inconsistent with the legislative intent. It creates a substantial disincentive to the use of charitable remainder trusts and charitable lead trusts that benefit grandchildren. The definition of the applicable fraction should continue to permit the denominator of the fraction to be reduced by the amount of any charitable deduction.

In the case of a charitable remainder trust, the change would mean that in order to exempt annual transfers to grandchildren from the generation-skipping transfer tax, GST exemption in the full amount of the trust principal must be used. For example, if a donor gives $100,000 to a charitable remainder trust to pay $10,000 a year for five years to his grandchild and then pay the principal to X charity, then, assuming the donor had already used his annual exclusion with respect to the grandchild, the donor would have to allocate $100,000 of GST exemption to avoid subjecting the five $10,000 annual payments to the generation-skipping transfer tax.

In the case of a charitable lead trust, the change would mean that a donor would be better off creating an accumulation trust to which GST exemption is allocated for a grandchild in an amount equal to the present value of the remainder interest than creating a charitable lead trust. Although it is true that permitting the charitable deduction to be deducted from the denominator of the applicable fraction would to some extent give an unintended benefit to a donor of a charitable lead annuity trust if the investment performance of the trust is better than that assumed by the I.R.S. tables, it is also true that not permitting such a deduction "penalizes" the donor of a charitable lead unitrust or the donor of a charitable lead annuity trust that does not outperform the tables. For example, under the Technical Corrections Act, if a donor creates a $300,000 charitable lead trust that is to pay $30,000 to charity each year for ten years, and then to pay the principal to the donor's grandchild, the donor would have to allocate $300,000 of GST exemption to the trust, so that, at the end of the tenth year (when the trust would, according to the tables, be worth $300,000) that full $300,000 would be exempt from the generation-skipping transfer tax, whereas if instead $115,662 had been put into a ten-year accumulation trust for the grandchild, then in 10 years, according to the 10% assumption of the I.R.S. tables, the grandchild would receive $300,000, and only $115,662 of GST exemption would have to have been allocated to the trust at creation to exempt the full $300,000 from the generation-skipping transfer tax.

A more thorough discussion of the reasons why present law should be retained will be included in a separate submission.

If the proposed change is made, then given the special nature of charities, if a charity has an interest and after the interest of the charity property passes to a skip person, a special rule should be added so that the transfer to the skip person is a direct skip, not a taxable termination or a taxable distribution. This rule would be similar to that provided in section 2642(e)(3) as proposed by TCA-1987. Without it the generation-skipping transfer tax that would be imposed at the termination of the charity's interest would be significantly greater than the tax that would have been imposed had the charity never had an interest.

If the provision in the Technical Corrections Act is retained, a transition rule should be added to give people who have charitable lead trusts in wills and revocable trusts time to change their documents.

4. Special Rules for Certain Inter Vivos Transfers.

Section 114(f)(5)(A) of TCA-1987 would add new section 2642(e). This section appears to have several technical problems:

(a) It is unclear how section 2642(e) works when property is transferred to a trust and immediately thereafter a portion (but not all) of the trust is potentially includible in the estate of the transferor. For example, if T transfers $100,000 to a trust and retains the right to receive an annuity of $6,000 a year, immediately after the transfer only $60,000 would be in it's gross estate. Does this mean the exemption could be allocated to the other $40,000? If so, how would this be done?

(b) Section 2642(e)(3) states that distributions made to skip persons before the transferor's death would be treated as a direct skip whether or not the transfer was subject to gift or estate tax. Further, it states that the transferor may allocate a portion of his GST exemption to it. It is not clear how this rule interacts with the automatic allocation provisions of section 2632(b). Wouldn't they apply to the transfer if it were a direct skip under this new provision?

(c) Perhaps most importantly, new section 2642(e) simply does not seem to work with respect to certain transfers outside the scope of section 2036. For example, if a transferor makes a taxable gift to a trust that is a skip person and over which the transferor retains section 2038 powers (which are not sufficient to prevent the transfer from being a taxable gift), generation-skipping transfer tax may be due prior to an effective allocation under section 2642(e) and prior to the valuation date prescribed by section 2642(e). This seems directly contrary to the deemed allocation rule of section 2632(e) and the policy behind it unless somehow a deemed allocation is treated as taking place outside of proposed 2642(e). A common example of a transfer that would have this problem is a transfer to a discretionary section 2503(c) trust for a grandchild with the transferor as the trustee. Another common example is a Uniform Gift to Minors Act transfer where the transferor is the custodian. If tax must be paid upon the transfer to the trust (because no allocation of exemption is effective) and property is subsequently distributed from the trust (or the Gift to Minors Act account), is the "skip person" determined in light of section 2653(a)? Will such a distribution be deemed a direct skip notwithstanding the treatment of the original transfer?

5. Support Obligations.

Section 114(f)(7) of TCA-1987 would add new section 2652(c)(3). It is unclear how this provision would apply to a trust that permits (but does not require) a trustee to use trust property for specific purposes such as a beneficiary's "health, support and education". The confusion arises from the words "if such use is not expressly provided for in the trust instrument". It would be more understandable if the provision stated that,

> "The fact that income or corpus of the trust may be used to satisfy an obligation of support arising under State law, shall be disregarded in determining whether a person has an interest in the trust unless the trust specifically provides that trust property shall be used to relieve another's obligation of support."

Unless the section is changed, it will be very difficult to draft a direct skip trust and still give guidance to the trustee as to how to use the property. The fact that a trust provides that a distribution may be made for a child's "support", "health", "education", etc., should not be treated as giving the parent an interest. Such a distribution will not necessarily "discharge" the obligation of support because the trust or the beneficiary may very well have a right of contribution against the parent.

6. Transferor.

Section 114(f)(10) of TCA-1987 would change the basic definition of the term "transferor" contained in section 2652(a)(1) by substituting the words "any property" for the words "a transfer of a kind" and by adding the following sentence: "An individual shall be treated as transferring any property with respect to which such individual is the transferor." This change is not fully explained in the Description. There appear to be two possible clarifications made by this change. It should be made clear if either or both were intended.

First, under this provision it appears that upon the lapse of a withdrawal power over a trust in an amount greater than $5,000 or 5% of the value of the trust, the power holder becomes the transferor to the extent of the excess and the original transferor remains the transferor with respect to the property up to the "five and five" amount. Thereafter, the trust would presumably be treated for generation-skipping transfer tax purposes as separate trusts with different transferors.

Second, the change in the definition of the term "transferor" seems to clarify that immediately upon property becoming subject to estate or gift tax with respect to an individual (and before it is determined whether or not a generation-skipping transfer has occurred), the individual becomes the new transferor and the old transferor drops out. This is consistent with the section 2652(a)(3) QTIP election. However, it appears that section 2611(b)(1) may be without significance.

The following example illustrates this last statement. Assume that a trust is created by A in which A's daughter, B, has a general testamentary power of appointment and on B's death the property passes to B's child (A's grandchild), C. Under the proposed new definition of "transferor," it seems clear that B is the transferor of the transfer to her child, C. As a result, section 2611(b)(1) is not needed to prevent the imposition of both a generation-skipping transfer tax and an estate tax on B's death (as C is a non-skip person with respect to B). If property instead passes to B's grandchild (A's great-grandchild), there would be a direct skip on B's death with or without section 2611(b)(1).

7. Separate Share Treatment.

Section 114(f)(14) of TCA-1987 would change section 2654(b) to add a sentence that states that: "Except as provided in the preceding sentence, nothing in this chapter shall be construed as authorizing a single trust to be treated as 2 or more trusts." It is not clear what was intended by this additional sentence.

This provision may effect trusts with multiple transferors (such as a trust created with jointly held or community property or a trust to which different individuals have made transfers) by restricting the Treasury from promulgating regulations to deal effectively with such trusts.

Multiple transferors can also result from a partial section 2652(a)(3) election. We assume this provision was not intended to prohibit such partial elections.

We also assume that this provision was not intended to imply that a transferor cannot by formula create two identical trusts, or that an executor or trustee, if permitted to do so by state law or the governing instrument, cannot divide a trust into two or more separate trusts. Allowing a taxpayer to divide a trust into more than one trust will not lead to abuse. Indeed, the purpose of the $1 million exemption was to take certain trusts out of the system for administrative reasons. Allowing trusts to be split into exempt and non-exempt trusts simply helps to facilitate the efficient administration of the generation-skipping transfer tax. Furthermore, as it is always possible to create a separate exempt trust during life or to create more than one trust in a testamentary document, forbidding the division of trusts would merely operate to the detriment of those who do not have sufficient assets to give away $1 million during life and result in a trap for those who do not realize that separate trusts are sometimes necessary to obtain the full benefit of the $1 million exemption or who do not anticipate that their assets will appreciate to over $1 million at the date of death. Thus, a prohibition on splitting trusts with different inclusion ratios would: (i) defeat the Congressional intent to give each taxpayer the ability to make a full $1,000,000 of generation-skipping transfers without generation-skipping transfer tax, (ii) cause many trusts to be partially taxable and partially exempt, with the associated difficulties for those paying the tax as well as for those enforcing payment, and (iii) require draftsmen to create multiple trusts to qualify for the full $1,000,000 exemption, thus increasing technical difficulty to no substantive end.

It should also be made clear, perhaps by regulation, that a permissible division of a trust after the exemption is allocated can result in separate trusts with different inclusion ratios, if the trustee so designates, based on the fair market value of the trust at the time of the division.

If a new rule is adopted which would prevent such divisions, a transitional rule should be added to give people whose estate plans are premised on the ability to divide, time to change their documents.

A more detailed discussion of this provision will be sent as a separate submission.

8. Effective Date Provisions.

Section 114(g)(2)(D) of TCA-1987 would amend section 1433(c) of the Reform Act to change the determinative date of incompetency from the date of enactment (October 22, 1986) to September 25, 1985. This change is inappropriate for three reasons. First, it is not a technical change but, rather, a substantive one. Second, it is not consistent with the other effective date and transition rule provisions included in the Act. Third, it is a change from the comparable provision in the House Bill (section 1223(b)(2)(B) of H.R. 3838), which was reported by the House Ways and Means Committee on December 7, 1985.

The determinative date for mental incompetency should be the same determinative date as that used for the transition rule with respect to wills executed before a certain date. Such a transition rule is intended to give individuals with existing documents an opportunity, after the date of enactment, to change those existing documents in order to take into account the newly enacted provision. A person who is incompetent on the date of enactment and thereafter until death has no opportunity to change the existing documents in order to take into account the new tax. Accordingly, just like the person who dies before the grace period, the incompetent individual should not be subject to the tax. Thus, as section 1433(c)(2)(B) provides that a transfer under a will in existence on October 22, 1986 is not subject to the tax if the decedent dies before January 1, 1987, so should October 22, 1986 be the relevant date for incompetency even where the decedent dies after January 1, 1987, provided that decedent was not capable of changing the will or other testamentary documents after that date.

While it is true that section 1433(c)(2)(A) of the Reform Act subjects certain inter vivos transfers made after September 25, 1985, to the tax, this is not the analogous provision. Irrevocable inter vivos transfers are made with the knowledge that the governing documents cannot be changed. This is not the case with testamentary documents. Such documents are always written with the idea that they will be changed to reflect changes in the law unless the person dies prior to such a change. If such a document cannot be changed, not by reason of death, but by reason of incompetency, the appropriate transition rule to apply would be the same provisions that would apply if the person had died on the date on which the person became incompetent. Certainly one entering incompetency after September 25, 1985, but before October 22, 1986, should not have been more alert to pending legislation than one competent to execute his will during such period, but who happens to die prior to January 1, 1987. Furthermore had a future incompetent in 1985 been alert to legislation he or she would have been alert to legislation that included a "date of enactment" date for the transition rule relating to incompetency.

9. $2 Million per Grandchild Exclusion.

Section 114(g)(3) of TCA-1987 would add section 1433(b)(3) to the Reform Act. It provides that certain transfers to a trust for a grandchild will qualify for the grandchild exclusion. This provision gives rise to several concerns:

(a) The requirement that income be distributed currently to the grandchild beginning at age twenty-one seems unnecessarily restrictive, and often does not make sense from a dispositive perspective. Such a requirement can be detrimental in the case of a normal grandchild and certainly would be detrimental in the case of a grandchild who is incapacitated or disabled. If the marital deduction is deemed to be an appropriate analog, the marital deduction estate trust should be considered just as analogous as the QTIP. As long as any undistributed income is includible in the gross estate of the grandchild, it would be subject to estate tax at the death of the grandchild and the transfer tax effect would be no different.

Several questions arise by virtue of the requirement that income be paid currently. For example, must the transferred property be income producing consistent with the requirement for the marital deduction? A more detailed discussion of the problems with this provision will be included in a separate submission.

If the current income requirement is retained it should be given a later effective date and an appropriate transition rule as it is inconsistent with the instructions to the newly released Form 709. Some people may have created irrevocable trusts and drafted wills or revocable trusts in reliance on the instructions in the federal gift tax return.

(b) Some confusion is created by the clause "(or for the benefit of)" in section 1433(b)(3)(B)(i) of the Reform Act. It should be made clear that the mere possibility that a distribution might be made that would satisfy someone's obligation of support would not disqualify a trust for the $2 million per grandchild exclusion. Certainly such a possibility does not prevent a similar trust from qualifying for the marital deduction. If a surviving spouse remarries and the new spouse has a legal obligation to support the survivor, the fact that trust property may be used to pay items of support does not disturb the marital deduction.

(c) It is not clear whether the election under section 1433(d) of the Reform Act for transfers made before the date of enactment are subject to the new income requirements of section 1433(b)(3)(B). If the new income requirement is retained, the Technical Corrections Act should make it clear that this requirement does not apply to determine eligibility of a trust for an election under section 1433(d) of the Reform Act.

Additional Items for Technical Corrections Act of 1987 to the Generation-Skipping Transfer Tax

1. Credit for Property Previously Taxed. Chapter 13 does not contain any credit for property previously subject to a GST tax or an estate tax under circumstances in which such property would be entitled to a credit under §2013 if the property were subject to estate tax rather than GST tax. It appears that §2611(b)(3) may have been intended to provide such a credit but it does not accomplish this result. The absence of a "PPT" credit in Chapter 13 creates an incentive

to avoid the GST tax by incurring an estate tax even where for other, non-tax reasons transferors do not want their beneficiaries to have the control over the property to the extent necessary to result in an estate tax. At least in the case of taxable terminations occurring on and as a result of the death of an individual this difference in treatment (between the estate tax and GST tax) creates serious inequities.

We recommend modifying §2611(b)(3) so that it operates as a PPT credit analogous to §2013. A more far reaching alternative (which we believe would be a substantial improvement to the tax) would be an election that would permit a trustee to avoid paying a GST tax on a taxable termination that occurs on and by reason of the death of an individual by agreeing to pay an estate tax on the trust property as if such property were included in the individual's estate.

2. Computation of Inclusion Ratio and Annual Exclusion Transfers. The computation of the inclusion ratio does not seem to work properly in the case of certain transfers that qualify for the annual exclusion. These problems do not appear to be fixed by §114(f)(12) of the Technical Corrections Act. However, these problems would appear to be solved if, instead of excluding annual exclusion transfers from the denominator of the applicable fraction as is provided in §2642(c), and instead of not requiring a recomputation of the inclusion ratio under §2642(d) on an annual exclusion addition, such transfers were included in both the numerator and the denominator of the applicable fraction for purposes of both §2642(a) and (d).

Consider the following example: Assume a trust to which $20,000 was transferred in 1988 of which $15,000 qualified for the annual exclusion. Assume further that in 1989 another $20,000 is transferred to the trust and again $15,000 qualifies for the annual exclusion. Also assume that immediately before the 1989 transfer the trust had a value of 20,000.

(a) If in 1988 no part of any GST Exemption was allocated to the trust (and the Applicable Fraction immediately before the second transfer was 0), and in 1989 5,000 of the GST Exemption is allocated to the new transfer, the recomputed Applicable Fraction is:

$$\frac{5,000 + (20,000 \times 0)}{5,000 - 0 + 20,000}$$

$$= \frac{5,000}{25,000} = \frac{1}{5} = 20\%$$

and the Inclusion Ratio is 80% (1-20%). Thus, tax due on the entire trust is reduced by only 20% even though with respect to transfers totalling $40,000, $35,000 qualified for either the annual exclusion or were covered by GST exemption.

(b) If in 1988 $5,000 of the GST exemption was allocated to the trust (so the applicable fraction immediately before the second transfer was 1), and in 1989 no portion of the exemption is allocated to the trust, then the recomputed Applicable Fraction is:

$$\frac{0 + (20,000 \times 1)}{5,000 - 0 + 20,000}$$

$$\frac{20,000}{25,000} = \frac{4}{5} = 80\%$$

and the Inclusion Ratio is 20% (1-80%) and the tax rate to which the trust is subject is reduced by 80%. Reversing the time of the GST allocation from example (a) has had a dramatic impact on the taxability of the trust even though nothing else has changed. This does not seem to be an appropriate result.

If the statute were modified as suggested then the results of the above examples would change as follows:

(i) In (a) above, the applicable fraction after the 1988 transfer would be computed as follows:

$$\frac{15,000}{20,000} = \frac{3}{4} = 75\%$$

and the Inclusion Ratio would be 25% (1-75%). After the 1989 transfer the recomputed Applicable Fraction would be

$$\frac{20,000+(20,000 \times 75\%)}{20,000+20,000}$$

$$= \frac{35,000}{40,000} = 87.5\%$$

and the Inclusion Ratio would be 12.5%

(ii) In (b) above, the Applicable Fraction after the 1988 transfer would be computed as follows:

$$\frac{20,000}{20,000} = 1$$

and the Inclusion Ratio would be 0. After the 1989 transfer the recomputed Applicable Fraction would be

$$\frac{15,000+(20,000 \times 1)}{40,000}$$

$$= \frac{35,000}{40,000} = 87.5\%$$

and the Inclusion Ratio would be 12.5% -- the same as (i). Certainly the more rational result is that, where values don't change, the timing of the allocation of the exemption does not affect the inclusion ratio.

3. Deemed Allocations to Lifetime Direct Skips. The general rule is that, unless the individual elects otherwise, the "unused portion" of an individual's $1 million GST exemption is deemed allocated to each lifetime direct skip of the individual in order of occurrence. §2632(b)(1). However, there appears to be a typographical error in the definition of the "unused portion". As written, it is defined as that portion that has not previously been allocated with respect to a prior direct skip. §2632(b)(2). Thus, it is arguable that a failure to elect out of this provision can undo a prior allocation to property in a trust that is not a Skip Person, because the transfer to the trust was not a direct skip. However, this problem evaporates if the close parenthesis in §2632(b)(2) is moved to the end of the sentence rather than after "(1)."

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WRITER'S DIRECT DIAL NUMBER

July 9, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I have reviewed the Technical Corrections Act of 1987 ("TCA 1987") and I have the following criticisms regarding Section 114 entitled "Amendments Related to Title XIV of the Reform Act":

1. Treatment of Distribution from Trust for Children of a Predeceased Child

Section 2612(c)(2) of the Internal Revenue Code of 1986 ("IRC") creates the so-called "predeceased child exception." Under this section, if property passes to the children of a deceased child, those grandchildren of the transferor (who are normally considered skip persons) move up one generation and are considered non-skip persons for purposes of determining whether a direct skip has occurred. If a trust is created for such grandchildren (with the intervening child predeceasing the transferor) no direct skip occurs upon the trust's creation because such a trust is not a skip person under the rule of section 2612(c)(2).

However, this special rule of section 2612(c)(2) applies only "For purposes of determining whether any transfer is a direct skip." Thus, distributions from the trust to the grandchildren are taxable distributions because the special rule of section 2612(c)(2) does not apply to taxable distributions (which are not direct skips) and the generation assignments of the trust and beneficiaries are not changed pursuant to section 2612(c).

As a solution, I recommend including in the TCA 1987 the following new paragraph (3) as an addition to section 2612(c) of the Internal Revenue Code of 1986:

> "(3) In the case of any transfer which would be a generation-skipping transfer but for paragraph (2), section 2653(a) shall apply as if such transfer were a generation-skipping transfer."

This new paragraph (3) would have the effect of lowering the generation level of the trust to that of the deceased child's generation; thereafter, distributions to the grandchildren would not be generation skipping transfers, but distributions to great-grandchildren would be. I believe this achieves the proper result. I have modeled this paragraph after subparagraph (C) of section 1433(b)(3) which has been proposed in the TCA 1987 as an amendment to section 1433(b)(3) of the Tax Reform Act of 1986 ("TRA 1986"). I believe that making this change would further the congressional intent that no generation-skipping transfer tax be generated where distributions are made to the children of a deceased child of a transferor.

Section 114(g) of the TCA 1987 clarifies the treatment of a $2 million gift (made before January 1, 1990) made for the benefit of a grandchild in trust (which under section 1433(b)(3) of the TRA 1986 is not a direct skip). The TCA 1987 replaces section 1433(b)(3) enacted as part of the TRA 1986 with an expanded set of rules. Subparagraph (C) of these expanded rules provides that even though no generation-skipping transfer has occurred, section 2653(a) of the Internal Revenue Code of 1986 shall be applied as if the transfer had been a generation-skipping transfer for the purposes of determining the generation assignment of the trust. The section 2612(c) situation is analogous to this situation since in both situations property is in trust for the benefit of only grandchildren and no generation skipping transfer has occurred. Therefore, I believe that the modification of section 1433(b)(3) of the TRA 1986 made in the TCA 1987 supports the analagous modification to section 2612(c) that I have recommended above.

2. Repeal of the Charitable Deduction as an Offset Against the Generation-Skipping Transfer Tax on Charitable Lead Trusts

I am strongly opposed to the changes made in Section 114(f)(4)(C) & (D) of the TCA 1987. The repeal of the charitable deduction in calculating the applicable fraction under IRC section 2642 is unsound for several reasons. First, the charitable lead trust is an accepted and widely used dispositive device; the charitable lead trust should not be singled out for harsher treatment than other dispositive devices because the bill drafters personally disfavor the use of such a device. Second, if valuation principles are to be uniform and the valuation tables are to be applied consistently, those principles and tables should be used in all situations where interests are valued. It makes no sense to value property passing to a charitable lead trust for purposes of calculating the applicable fraction of that trust in one manner and to value the property for estate or gift tax purposes in another manner. Carving out an exception seriously undermines any attempt by Congress to implement a uniform system of property valuation for estate, gift and generation skipping transfer tax purposes. Third, this change appears to be a substantive change to the IRC and I do not believe that the TCA 1987 is the proper forum to be making such changes.

Sincerely,

John R. Cohan

John R. Cohan

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PLEASE RESPOND TO

Cleveland

July 31, 1987

Hon. Dan Rostenkowski
Chairman, House Ways and Means Committee
House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987, H.R.2636, and the Tax on Generation-Skipping Transfers

Dear Mr. Rostenkowski:

The provisions of the Technical Corrections Act, as they apply to the generation-skipping tax, will generally be welcomed by estate planning lawyers, at least assuming that we have to live with the new generation-skipping tax (I personally found its predecessor vastly preferable), with the three exceptions about which I should like to comment in this letter. Then I would like to offer a suggested new approach. First, my three criticisms of H.R. 2636, as follows:

1. Section 114(g)(3) of the Technical Corrections Act would amend Section 1433 of the Tax Reform Act of 1986, so as to make clear that a transfer in trust for the benefit of a grandchild, before January 1, 1990, would qualify for the special $2,000,000 exemption from the tax on generation-skipping transfers, if certain conditions are met, to the same extent as would an outright transfer to the grandchild. This clarification is welcome, but I submit that one of the conditions imposed upon the gift in trust qualifying is unnecessary, and if enacted could work an unfairness on those who have tried in good faith to qualify trust gifts to grandchildren prior to the provisions of the Technical Corrections Act having become generally known.

Paragraph (3)(B) of Section 1433(b) of the Tax Reform Act of 1986, as modified by Section 114(g)(3) of the Technical Corrections Act; would permit a gift in trust for the benefit of a grandchild to qualify for the $2,000,000 exemption, if made before January 1, 1990, "if (and only if)" three conditions were met:

1. During the life of the grandchild, no portion of trust principal or income may be paid to or for the benefit of anyone other than the grandchild (this requirement could have been anticipated by most expert practitioners);

2. The trust assets must be included in the grandchild's gross estate if the grandchild dies before the trust terminates (this requirement also could have been anticipated by most expert practitioners); and

3. All of the trust income will be distributed to the grandchild at least annually, after the grandchild has attained age 21 (this requirement could not have been reasonably anticipated, and is the one to which I object).

There may be social policy or revenue reasons, justifying an all-income-must-be-distributed approach in connection with marital deduction trusts and qualified Subchapter S trusts, but I see no justification for such a requirement in order that a grandchild's trust qualify for the special $2,000,000 exemption.

Moreover, many practitioners, accustomed to drafting trusts for grandchildren that would qualify for the old grandchild's exclusion under the previous generation-skipping tax, may well have used the same drafting approach in attempting to qualify trust gifts for grandchildren for the special $2,000,000 exemption under the new tax, prior to having had an opportunity to review the Technical Corrections Act. There was no requirement that income be distributed, after age 21, in order to be eligible for that old grandchild's exclusion.

Furthermore, Section 1433(d) of the Tax Reform Act of 1986 provided (somewhat inartfully, requiring clarification by Section 114(g)(4) of the Technical Corrections Act) a "relief" provision by which certain transfers in trust for grandchildren might qualify for the $2,000,000 exemption. The focus there was on inclusion of the trust in the grandchild's estate -- not on any requirement that income be distributed. This may well have misled practitioners into assuming there would be no income-distribution requirement.

From a revenue standpoint, if a trust for a grandchild were permitted to accumulate income, under certain circumstances, while still qualifying for the $2,000,000 exemption before 1990, there could at most be minimal cost to the U.S. Treasury, and that minimal cost would result only rarely. In most cases additional tax revenues would be generated.

Let me illustrate, first with regard to income taxes. Assume $10,000 of income, which might be retained in trust or alternatively distributed to a grandchild, who was over age 21 and had no other income and no deductions. If retained in the trust, against that $10,000 of income there could be subtracted only the trust's $100 personal exemption, and perhaps a small amount of deductions. Disregarding the potential de minimus deductions, the trust would have taxable income of $9,900, on which it would owe tax of $2,122. By contrast, if the $10,000 of income were distributed to the grandchild, there could be subtracted therefrom a personal exemption of $1,900 and a standard deduction of $2,540, leaving the grandchild with taxable income of $5,560 on which tax of $834 would be imposed. The governmental revenues would thus be enhanced by nearly $1,300 if the trust accumulated the income, rather than distributing it to the grandchild.

Now vary the example by assuming the less likely case where the grandchild, instead of having no other income, had enough other income to be placed in the 33% bracket. Then, if the $10,000 of trust income were distributed to the grandchild his tax on it would be $3,333 compared with $2,122 in tax if the trust had retained the $10,000 of income. Here I must concede that about $1,200 in tax would be saved by retaining the income in the trust. But this circumstance -- modest trust income, and a grandchild with very substantial other income -- will seldom be encountered. Furthermore, in most cases the slight tax advantage gained in this circumstance would be only temporary, because the throwback rule of Section 665 et seq. would eventually reach the accumulated trust income when it was distributed.

Now let's assume $200,000 of trust income, rather than $10,000. If accumulated in the trust, again ignoring deductions, but allowing for the phaseout of the personal exemption, the entire amount of income would be subject to a flat 28% tax rate, generating a tax of $56,000. That is exactly the same tax liability that the grandchild would have, if the income had been distributed, after taking into account the phaseout of the standard deduction and personal exemption.

In the above examples, I have ignored the possibility of a trust having some deductions in computing its taxable income. I think it is a fair assumption that any deductions the trust might have would also be available to a grandchild receiving all of the trust income, or that the grandchild would have other, equivalent deductions. Thus I believe it is an accurate generalization to say that the income tax revenue consequences would be negligible if income were retained by and taxed to a trust rather than being distributed to and taxed to a grandchild.

Now let's look at the estate tax side. If the income were retained in the trust, and the grandchild died before the trust terminated, the retained income as well as trust principal would be subject to inclusion in the grandchild's gross estate. If on the other hand the income were distributed to the grandchild, and not spent, it would also be included in the grandchild's estate, so that the estate tax consequences would be the same, whether the income were accumulated or distributed. However, perhaps at this point one should take into account human nature. If the income were distributed to the grandchild, there is greater likelihood that it would be spent by the grandchild, and thus not be subject to estate taxation, than if it were retained in the trust. Thus, retention of income in the trust would probably produce more revenues, from an estate tax standpoint, than would distribution of that income.

In view of the foregoing, I would urge that before H.R.2636 is enacted, clause (iii) of paragraph (3)(B) of Section 1433(b) of the Tax Reform Act of 1986, as amended by Section 114(g)(3) of the Technical Corrections Act, should be deleted, so that the only requirements for a trust for a grandchild qualifying for the $2,000,000 exemption, in the case of transfers before 1990, would be that the trust have no other beneficiaries than the grandchild during the grandchild's lifetime, and that the trust property be included in the grandchild's estate if the grandchild died before the trust terminated.

2. Section 114(f)(15) of the Technical Correction Act prohibits the division of a trust that is partially exempt from the generation-skipping tax. It would greatly simplify the administration of trusts and the compliance with the generation-skipping tax, while not opening the door to much tax minimization if any, if Section 114(f)(15), as it applies to Section 1431 of the Tax Reform Act of 1986 and Section 2654 of the Code, were reconsidered, so as to permit a single trust to be divided into two separate trusts, one entirely subject to the generation-skipping tax and the other entirely exempt therefrom. Experts in the preparation of wills and trusts can draw instruments so as to get around this problem, albeit at the cost of quite a bit of complexity in the documents, extra fees to be paid by the clients, and the clients not understanding the necessary technical language that they will encounter in their wills and trusts. Why not spare the experts and their clients the trouble, and assist those who might not be all that expert, by doing away with or at least relaxing this proposed rule? The more liberal approach exemplified by the regulations issued in connection with qualified terminable interest property would, in my estimation, be the preferred approach. Under those regulations, a trustee may, in the case of a trust that is partially qualified for the QTIP marital deduction, either divide the trust into two separate trusts, one entirely qualified and the other not qualified at all, if authorized by the governing instrument, or alternatively may separately account for distributions from the trust as having been made from either the qualified or non-qualified portion, even without the governing instrument so authorizing. I submit that a similar approach should be taken with respect to trusts that are partially exempt from the generation-skipping tax.

3. Section 2612(c)(2) of the Internal Revenue Code of 1986 is untouched by H.R.2636, but should be modified. This is the provision that says in effect that a gift or bequest to a grandchild or more remote descendant of the transferor (or the trans-

feror's spouse) won't be treated as a direct skip if there is no living person who is an ancestor of the transferee and a descendant of the transferor (or his spouse). I urge that this relief be extended to all persons descended from the grandparents of the transferor or his spouse, so as to preclude there being a direct skip where, for example, a childless transferor leaves property to a grandnephew or grandniece whose parent (the transferor's niece or nephew) is deceased. I cannot understand why Section 2612(c)(2) was enacted with such a narrow exception to the direct-skip rule in the first place. I see no policy reason why a gift to a grandniece whose parent is dead should be a direct skip, but a gift to a grandchild whose parent is dead should not be, and I urge that this invalid distinction be eliminated by the Technical Corrections Act.

Now for the new approach which I propose, which is: **A new provision should be added to the generation-skipping tax that would permit a transferor (or his Executor) to elect that a trust for the benefit of a child or any other person one generation down from the transferor would be included in the beneficiary's gross estate, in whole or in part, so as to make the estate tax rather than the generation-skipping tax apply to the trust.** I propose that this would be much like the QTIP election for marital deduction purposes, and for purposes of illustration let me refer to the trust as to which such election was made as a "qualified taxable estate trust" or "QTET". In brief, it would work like this:

> (1) The transferor (or his Executor) could elect that all, or a part (expressed as a fraction or percent), of the trust be a QTET, if the trust was for the exclusive benefit of a beneficiary one generation down from the transferor; provided, however, that persons to whom such beneficiary owed a legal obligation of support would also be permissible beneficiaries. There would be no requirement that trust income be paid to the beneficiary after he was age 21, for the same reasons as I have expressed above in commenting about Section 114(g)(3) of H.R.2636.
>
> (2) To the extent the election was made, the QTET would be included in the beneficiary's gross estate (just as Section 2044 includes QTIP).
>
> (3) The QTET would be liable for the incremental estate tax generated by its inclusion in the gross estate unless the beneficiary directed otherwise in his Will (just as §2207A provides as to QTIP).

Adoption of this proposal, or one akin to it, would greatly simplify the preparation of wills and trusts for the vast majority of clients, who want property held in trust for their children (or nieces and nephews) until they attain some stated age, usually 25 to 40 or thereabouts. Their motives are not to save estate taxes if their beneficiaries die young, but are simply to protect those beneficiaries until they reach the age of presumed fiscal maturity. Rather than rely on the $1,000,000 GST exemption, even though it will often be adequate, many of these clients would choose the QTET alternative because of its simplicity and because they simply don't care whether the trust property is taxed in their beneficiaries' estates.

Adoption of this proposal would also help better accomplish one stated purpose of the generation-skipping tax, which is to eliminate the differences in tax consequences as between trust and outright dispositions. A 50% flat-rate tax, with no unified credit, hardly accomplishes that purpose, where the trust beneficiary is not wealthy in his own right. An optional QTET treatment would.

Whatever attention that you and your staff, and your Senate counterparts, may give to the above will be most appreciated.

Sincerely,

L. L. Knowlton

LLK:dm

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July 7, 1987

Mr. Rob Leonard
Chief Counsel
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Dear Mr. Leonard:

Thank you for providing us with the opportunity to provide comments concerning H.R. 2636, the Technical Corrections Act of 1987. This letter is in regard to two provisions relating to trust taxation.

The Tax Reform Act imposed a requirement that trusts and certain estates file estimated quarterly tax payments on the same basis as individuals. Under this requirement, trusts and estates will have the same fifteen days from the close of the tax period to make estimated tax payments that is provided to individuals.

While trusts and estates are taxed in the same general manner as individuals, the filing of a fiduciary tax return by a fiduciary is a far more complicated event than the filing of an individual return by an individual. Because of the fiduciary relationship between the trustee or executor and the beneficiaries, fiduciaries will be required to calculate the actual tax liability owed each quarter with as much precision as possible. Unfortunately, due to the complexity and number of steps which need to be taken in calculating the actual tax liability each quarter, it is physically impossible to meet the fifteen day deadline.

For example, to calculate the tax on capital gains (which is generally the only item of taxable income for simple trusts) the trustee needs information relating to the sale of capital assets. This information is not generally available until the settlement date of the transaction, generally five days after the transaction has occurred, not including mailing time.

Tax liability must then be computed, and a decision made as to how to raise the funds to pay the tax. It will then take five to eight additional days to receive the funds to pay the tax once the transaction has been completed. The form still needs to be prepared, and a check drawn and remitted to the IRS.

If the trust invests in a common trust fund, information as to items of income, gains and losses is not even available to the trust until the fifteenth day following the period in question, the same day the estimated tax payment by the trust is due. Furthermore, cash withdrawals to pay the tax are not available until the first day of the following month, well past the filing deadline.

An amendment to the Technical Corrections Act which takes into consideration the differences between individuals and trust and estates by providing fiduciaries with fifteen additional days to make estimated tax payments would provide the minimum amount of time necessary to accurately calculate a trust's quarterly tax liability.

The Technical Corrections Act also includes a provision which would require common trust funds to adopt a calendar tax year. This provision was apparently included in the Technical Corrections Act in order to conform the treatment of common trust funds to the treatment of trusts.

Under the Tax Reform Act, all trusts were required to adopt a calendar tax year. Common trust funds, which are investment entities the investors of which are trusts, are not by definition trusts. They were therefore not required by the Tax Reform Act to adopt a calendar tax year. The requirement that common trust funds adopt a calendar tax year will create serious administrative and operational difficulties for trust fiduciaries.

Historically, most common trust funds have operated on a fiscal year. This allows the trustee to calculate the taxable income of the fund and to allocate that income to participant trusts prior to the end of their tax years. As a result, the preparation of the participant trust's tax return is not impeded.

If a common trust fund is required to adopt a calendar year, it will not calculate its income for the fund until January 15th, and will not complete providing the information to the participant trusts until January 31. It would therefore be impossible for trustees to include on a timely basis common trust fund information when calculating the estimated tax payments due January 15. It would also significantly delay the preparation of the fiduciary return, including informing the beneficiaries of this reportable income.

We therefore respectfully request that common trust funds be allowed to maintain current fiscal years. If it is inevitable that a change is to be required, common trust funds should be placed on a November 30th fiscal year. This will enable common trust fund trustees and beneficiary trust fiduciaries the minimum necessary amount of time to compile the information to prepare the trust tax return with respect to the income of the common trust fund. It is also essential that this change become effective in 1988 so that there will be no conflict with the change of all participating fiscal year trusts.

Thank you again for the opportunity to comment on these issues. We are hopeful our concerns can be addressed during the mark-up of technical corrections legislation.

Sincerely,

Michael P. Smith
Group Vice President
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Section 1402

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July 1, 1987

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1102 Longworth House Office Building
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Dear Mr. Leonard:

This letter is a comment on a proposed amendment to Sec. 673 contained in Section 114(b) of the Technical Corrections Bill of 1987 (H.R. 2636). The reason for the comment is that in its present form the amendment would create an unintended conflict between Sec. 673 and Secs. 676 and 677.

If a grantor creates a trust under which the trustee can pay income or principal to the grantor or the grantor's spouse, depending on the extent of the power the trust will be in whole or in part a grantor trust under Secs. 676 and/or 677. However, these sections do not apply if the discretionary power is excercisable by (or, in the case of Sec. 677, requires the consent of) an "adverse party". Sec. 672(a) defines "adverse party" as a person "having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power".

Under Sec. 673 the grantor is treated as the owner of any portion of a trust in which he has a "reversionary interest" in income or principal if as of the inception of the trust the reversionary interest exceeds 5% of the value of the trust. (Under Sec. §672(e) the grantor will be treated as owning any interest held by his spouse.) Sec. 673 does not have any reference to "adverse parties".

The regulations under Sec. 673 do not resolve the question whether, as a general rule, a trustee's discretionary power to pay income and/or principal to the grantor is a "reversionary interest" for purposes of Sec. 673, nor does any case or ruling.*

The Technical Corrections Bill would add a new subsection 673(c), to read as follows:

> "(c) Special Rule For Determining Value of Reversionary Interest.-For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum excerise of discretion by the fiduciary in favor of the grantor."

This language implies that a trustee's discretionary power to pay income or principal to the grantor is a reversionary interest. If that is a correct reading, then Sec. 673 will apply to such a power whether or not held by a trustee who is an adverse party, because Sec. 673 has no exception for adverse parties. In effect, the adverse party exception of Secs. 676 and 677 would be indirectly repealed in any case where maximum exercise of the discretion produces an interest greater than 5%.

Assuming that Congress does want to treat an interest pursuant to a discretionary power as a "reversionary interest", it seems unlikely that it wants to do so where the discretion is held by an adverse party, because that contradicts the policy of Secs. 676 and 677, which are the sections specifically targeted at (among other things) discretionary powers.

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* Rev. Rul. 61-223, 1961-2 C.B. 125, held that a corporate trustee's discretionary power to use trust property for support and maintenance of the grantor's minor child did not give the grantor a "reversionary interest" for purposes of Sec. 673. However, this holding was based on Sec. 677(b), which specifically covers that type of payment and precludes taxing the grantor under "any other provision". The ruling held that the grantor did have a reversionary interest under Sec. 170(b)(1)(D) as in effect prior to the Tax Reform Act of 1969. Old Sec. 170(b)(1)(D), however, had specific language making an interest under a discretionary power a "reversionary interest", and that language had an adverse party exception.

I suggest, therefore, that proposed Sec. 673(c) be clarified by adding the following language at the end thereof:

> "provided, however, that a power to distribute income or principal to the grantor shall be treated as a reversionary interest only if exercisable by the grantor or a nonadverse party or both, without the approval or consent of any adverse party."

If I am wrong and Congress does intend Sec. 673(c) to cover the adverse party case, the language still needs clarification because it refers only to "the fiduciary" and can therefore arguably be avoided by conferring the power on, or requiring the consent of, an adverse party who is not a fiduciary. To correct this, the words "discretion by the fiduciary in favor of the grantor" should be deleted and the following language should be inserted in place of them:

> "any power exercisable in favor of the grantor and the maximum consent to such exercise by any person whose consent is required"

This change could be combined with the change discussed above if the intent of Congress is to cover powers whether or not held in a fiduciary capacity but not those held by an adverse party.

Finally, it may be that Congress does not intend that an interest under a discretionary power to be treated as a "reversionary interest," and that proposed Sec. 673(c) is aimed only at a situation where the grantor has a "true" reversionary interest but the discretion can be exercised to cut down that reversion. For example, the grantor creates a trust to pay income to his child for 15 years, after which any remaining principal reverts to the grantor, but the trustee has discretion to pay principal to the child during the trust term. The effect of Sec. 673(c) would be to value the grantor's reversion assuming no payments of principal to the child.

If Sec. 673(c) is aimed only at this type of case, it should be clarified by adding the following language after the words "For purposes of subsection (a)":

> "if the fiduciary has discretion that could be exercised to reduce the property in which the grantor has a reversionary interest,"

I would be happy to discuss the issues raised in this letter with you.

Sincerely,

Dan T. Hastings

Section 1403

Marshall & Ilsley Trust Company
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July 15, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987

Dear Mr. Leonard:

I am writing to express my concern about the requirement created by the Tax Reform Act of 1986 that Trusts, as well as other entities, that currently report their income on fiscal year ends, adopt calendar year ends as of 12/31/87. It has come to my attention that there is a proposal in the Technical Corrections Bill of 1987 to allow existing S Corporations, Partnerships and Personal Service Corporations to retain their fiscal year status. Trusts were not included in that proposal.

I would appreciate it if you would consider also allowing trusts to retain their fiscal years for the following reasons, and I am including suggestions as to how that adjustment to the law could be revenue neutral.

1. Any deferment of income that occured took place in the first year of the trust's existance. After the first year all trusts report a full twelve months of income each year.

   This "loophole" of deferring the income in the first year of a trust could be closed by requiring all newly created trusts to select calendar years.

   If the committee believes that revenue must be raised to allow trusts to retain fiscal years, a deposit based on the tax calculated on the deferred income could be required. This is similar to the requirements proposed for Partnerships, S Corporations and Personal Service Corporations.

2. Requiring all existing trusts to change to calendar year status will place a tremendous burden on not only my department (The Tax Department of a large midwestern Trust Company) but on Tax Practitioners, Accountants, Attorneys and the I.R.S.

   Approximately 70 percent of our filing requirements now fall on April 15. If we are required to increase that to 100 percent, our staffing will be severely disrupted. We may have to eliminate full time positions and replace them with temporary seasonal help.

3. Trusts are now required to pay estimates. This is a revenue raising event because current income is no longer deferred for up to 12 full months. Income is calculated quarterly and estimates based on the annual tax are paid.

4. The income beneficiaries will be penalized in a manner which I believe is unfair. They will be required to report 1/4 of the income earned by the trust during the short period ending 12/31/87. This is in addition to the full year's worth of trust income that they are already required to report. The rates for 1987 are blended and often quite high.

   These beneficiaries are often persons under disability who rely on all of their income to meet their living expenses.

5. Even an individual taxpayer, as well as S Corporations, Partnerships and Personal Service Corporations, can elect a fiscal year if there is a valid business purpose. Now, under the Tax Reform Act of 1986 Trusts are singled out as being the only taxpayers that are forced to use calendar years.

6. Estates are allowed to use fiscal years for ease of administration in winding up a decedent's affairs. Often trusts are used for the same purpose and operate in lieu of a formal estate.

Thank you for taking the time to review my concerns and suggestions. I would appreciate your comments regarding my proposals.

Very truly yours,

Christoph F. Gloe

Christopher F. Gloe
Assistant Vice President

kas

Marshall & Ilsley Trust Company
770 North Water Street/Milwaukee, Wisconsin 53202/Tel 414 765-7520

July 15, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: 1987 Technical Correction Tax Act

Dear Mr. Leonard:

I am writing regarding a provision in the Tax Reform Act of 1986, which is of tremendous concern to me. The new Tax Reform Law requires trusts which were formally permitted to use fiscal years to change to the calendar year as of December 31, 1987.

This requirement would cause an increase in our tax season work load (which is already the busiest time of the year) by 35 percent. Realizing the Tax Reform Act of 1986 also requires trusts to make estimated tax payments, which will result in increasing revenue, the calendar year requirement cannot possibly produce much additional revenue. The calendar year requirement is an extremely inefficient way of raising tax revenues.

There are many small trusts which should not have to bear the increased administrative cost of this requirement. Most of the small amount of revenue produced by the calendar year requirement is caused by lumping additional income into the 1987 tax year where deductions have been eliminated and the rates have not been fully phased in.

If it is felt the small amount of revenue generated by the calendar year requirement is necessary to keep the total tax act revenue neutral, a requirement could be imposed on trusts to deposit additional tax with the Internal Revenue Service based on the income being deffered. This amount could be adjusted up or down if the deffered income changes substantially.

Eliminating or modifying the calendar year requirement should receive immediate attention. If the requirement goes into affect on December 31, 1987, it would create tremendous additional work to change back to fiscal years. I cannot emphasize enough the burden created for all practioners with the relatively small amount of revenue that could be produced. Even a grandfathering provision for all existing trusts would go a long way to making this provision workable.

I'd be happy to discuss this with you, you can call me at (414)287-7146.

Very truly yours,

John P Mitchell

John P. Mitchell
Assistant Vice President

kas

SOVRAN
BANK

July 16, 1987

Ways & Means Committee
U. S. House of Representatives
Washington, DC 20515

Gentlemen:

This is in response to an alert that there is a recommendation that not only should Common Trust Funds be switched to a calendar year but it would be retroactive to 12/31/86.

That proposal would not only create havoc with Trust Tax Departments but would also mean amended returns for all returns filed which do not reflect 12/31/86 common trust income. The anxiety and worry of the elderly that have trusts would be impossible to live with under such a proposal.

In the real world the proposed changes along with the new tax year change for trusts is a loss in time, money and effort not only for taxpayers but the IRS and tax practitioners.

A specific example is the new law requiring estimated taxes for trusts and estates. We have complied with this change using the estimated tax forms from the IRS. What happens? The IRS has been refunding the estimates saying no tax is due.

In simple words there is or was no tax being avoided under the old rules but the new law just takes it up front sooner. For all the expense and time involved in the new law and proposals for both the IRS and the citizens of this country, everything was better before the changes. What the Treasury is getting based on my understanding of the projection is $500,000,000.00 in 1987 instead of 1988. The cost for this one time up front change will exceed that amount in terms of fees and other costs to the IRS, taxpayers and tax practitioners.

Regarding the Common Trust Fund proposal I'm sure you are aware that the original new version of change to calendar year did not have any mention of Common Trust Fund. It seems that the only fair thing to do if you must persist in calendar year reporting is to at least make it effective some time after it is made law.

Please reconsider this whole package of laws and proposals and eliminate them.

Sincerely,
S J Grande
S. J. Grande, CPA
Trust Tax Officer/AVP

Trust Division · Sovran Bank · Maryland
6610 Rockledge Drive · Bethesda, Maryland 20817
Telephone 301 493 2902

TRUST

Financial Services
Division

Texas Bankers
Association

203 West 10th St
Austin, Texas
78701

512 472-7391

July 9, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Texas Bankers Association Trust Financial Services Division is submitting these comments on the impact on banks of the proposed Technical Corrections Act of 1987 proposal to require common trust funds to use a calendar year beginning in 1987. The Association represents more than 300 bank trust departments that offer fiduciary services in the Soutwest.

As you know, the Tax Reform act of 1986 required partnerships and other entities to adopt a calendar year for their tax years beginning after December 31, 1986. It, however, made no change in common trust funds' year end selection. Common trust funds are utilized by corporate fiduciaries to diversify the investments of smaller trust accounts. The recently proposed "technical" corrections to require common trust funds to adopt a calendar year beginning in 1987 is a substantive change.

That proposed requirement will impose a hardship on the ability of trust beneficiaries' to timely file their individual tax returns, because the necessary accounting for the common trust funds by the corporate fiduciaries would occur in January of each calendar year. This coincides with the time for preparation of the fiduciary tax returns for trusts which now are also required to adopt a calendar year. A delay in issuing the tax information from the common trust funds to the participating trusts will further delay the issuance of timely tax information to the trust beneficiaries. The final result is the trust beneficiary is then delayed in filing his individual tax returns.

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If common trust funds are allowed to retain a fiscal year end, the accounting, balancing, and issuance of tax information could be accomplished prior to the end of the calendar year. This would allow the timely preparation of the fiduciary returns and, in turn, the timely filing of individual returns by trust beneficiaries. Permitting common trust funds to retain a fiscal year end would result in no revenue loss to the Treasury because trusts are required to report income received from a common trust fund in the trust's tax year in which the common trust fund's year ends. For example, a trust having a December year end and holding units of a common trust fund having a November year end would report gains and losses from the fund's 12 months ending in November and the trust's calendar year return.

We appreciate the opportunity to comment on this provision of the bill. We urge the Committee to remove the common trust fund provision from the legislation.

Sincerely,

Scott A. Blech
Executive Director

SAB/kt

copy: The Honorable J. J. Pickle
The Honorable Bill Archer

Section 1411

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AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

July 10, 1987

Honorable Dan Rostenkowski, Chairman
House Ways And Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515

Re: Unearned Income Of A Minor Child

Dear Chairman Rostenkowski:

Your help is needed in correcting an unfair tax burden placed on three minors - a girl age 11 and twin boys age 6.

The House Bill would not have taxed a minor's unearned income derived from assets received from sources other than a parent that was placed in a qualified segregated account at the child's rate. Unfortunately, the Senate Amendment and the Conference Agreement taxes all unearned income of a minor, regardless of its source, at the parent's top bracket.

In brief, my situation involves three minors whose mother was killed in an automobile accident in 1983. Judgment was awarded the three minors in the lower court, affirmed on appeal and writs to the Supreme Court were denied. In Louisiana interest runs on a judgment from the date of judicial demand. Thus, each of the three minors received in 1987 approximately $50,000 of interest income on their judgment. Each will have to pay federal income tax of approximately $19,250 (38.5% X $50,000) instead of approximately $13,000 as a single individual.

For your information I have attached a copy of the case.

Your consideration in correcting this inequity is appreciated.

Very truly yours,

Pepperman, Emboulas, Schwartz & Todaro

By: L.A. Emboulas
Partner

missable. See *State v. Andrishok*, 434 So.2d 389 (La.1983).

[1] A police officer may stop a person in a public place whom he reasonably suspects is committing, has committed, or is about to commit an offense, and may demand his name, address, and an explanation of his actions. *Terry v. Ohio*, 392 U.S. 1, 88 S.Ct. 1868, 20 L.Ed.2d 889 (1968); La.C.Cr. Art. 215.1; *State v. Belton*, 441 So.2d 1195 (La.1983), cert. denied 466 U.S. 953, 104 S.Ct. 2158, 80 L.Ed.2d 543 (1984). Reasonable cause for an investigatory stop is something less than probable cause and must be determined by the facts in each case. The police officer must have articulable knowledge of particular facts to reasonably suspect the detained person of criminal activity and thus to justify the infringement on the individual's rights to be free of governmental interference. *State v. Sims*, 426 So.2d 148 (La.1983); *State v. Williams*, 421 So.2d 874 (La.1982).

[2] Detective Pritchett observed the defendant leaning into the vehicle and reasonably concluded the defendant was going through the glove compartment. The defendant walked away as he went through papers and threw them on the ground. At that point the detective had reasonable cause to believe the defendant had burglarized the vehicle.

When Detective Pritchett asked for identification and the dropped wallet revealed the driver's license of another man, the reasonable suspicion ripened into probable cause to arrest.

The defendant's pro se emphasis is on the detective's testimony that he became suspicious because the defendant was a black man in a predominantly white neighborhood. However, the defendant fails to note the other articulable circumstances which support the investigatory stop. In addition, the officer testified that he would have stopped a white man under the same circumstances.

Since there was reasonable cause to stop the defendant, the abandoned wallet was properly admitted into evidence. *State v. Chopin*, 372 So.2d 1222 (La.1979).

The defendant's conviction and sentence are affirmed.

AFFIRMED.

Donald J. HELLMERS, Jr., et al.

v.

DEPARTMENT OF TRANSPORTATION AND DEVELOPMENT, State of Louisiana, et al.

No. CA-6049.

Court of Appeal of Louisiana,
Fourth Circuit.

Feb. 12, 1987.

Rehearings Denied March 19, 1987.

Husband brought action against state Department of Transportation and Development and its insurer for alleged negligence causing automobile accident which killed his wife and injured his two minors sons. The Civil District Court, Parish of Orleans, Richard J. Ganucheau, J., awarded plaintiff $1,022,523.53 in damages against two defendants in solido, and parties appealed. The Court of Appeal, Klees, J., held that: (1) apportionment of fault of was reasonable; (2) amount of general damages awarded was not excessive; and (3) plaintiff's insurer could not recover amounts it paid to parties who were not made part of litigation as result of accident from defendants.

Modified and affirmed.

1. Automobiles 🔑279

Assignment of 85 percent of fault for automobile accident to Department of Transportation and Development was warranted given Department's high duty to warn motorists of risks which Department itself had created where there was a failure of appropriate safety measures, such as signs, proper flagging procedure, or proper placement of cones around Department truck which was stopped on bridge under maintenance.

2. Automobiles ⇐284

Assignment of 15 percent of fault to motorist for collision with oncoming car was reasonable; although Department of Transportation and Development failed to follow proper safety procedures in blocking off one lane of traffic, other drivers were able to stop their vehicles safely, but there was no evidence that motorist was speeding and she did not have the benefit of a flagman, which the drivers of stopped vehicles may have had.

3. Negligence ⇐98

Fifteen percent reduction for comparative negligence of mother who was driving vehicle at time of collision applied to amount representing pain and suffering of her two minor sons who were passengers and were injured in accident, as defendants could be required to pay no more than 85 percent of damages of any injured person, even guest passenger under comparative negligence law.

4. Insurance ⇐435.38

Department of Transportation and Development truck was "in use" within meaning of Department's liability policy where truck was being used to block highway and as part of warning system implemented by Department employees, truck's engine and light were left on, and employees kept various tools they might need in truck during time they were working on bridge, which was normal use for truck according to testimony of Department officials.

5. Damages ⇐132(1)

Award of $25,000 assessed for pain and suffering of two young children who were injured while passengers in automobile at time of collision was reasonable where they had had surgery, spent nearly two weeks in hospital, had residual abdominal pain for six to eight months, and one had permanent scar on his forehead.

6. Death ⇐99(4)

Total award of one million dollars to husband and his three children for the loss of his wife in automobile collision caused by negligence of Department of Transportation and Development was not beyond court's discretion; wife was 30 years old at time of death, couple had a good marriage and wife was devoted mother to her three young children, had many other talents and hobbies such as painting, sculpture, pottery-making and gardening, and had recently reapplied for job which she had held before the birth of her twin sons.

7. Interest ⇐46(1)

Date of judicial demand for purposes of calculating interest award was date insured was sued, rather than date insurer was added as defendant, where insured and insurer were solidarily liable. LSA-R.S. 13:5106.

8. Insurance ⇐598.1

Insurer's liability for interest on judgment was not limited to one million dollar policy limits where judgment correctly assessed interest on entire award against both insured and insurer in solido.

9. States ⇐112(2)

Statute limiting general damages against state of Louisiana to $500,000 did not apply retroactively to case involving accident partially caused by negligence of Department of Transportation and Development more than two years before effective date of statute. LSA-R.S. 13:5106.

10. Negligence ⇐98

Defendants found to be 85 percent liable in causing automobile accident were not entitled to reduction of judgment against them by 15 percent to reflect negligence of automobile insurer's insured where entire judgment had already been reduced by 15 percent to reflect such negligence.

11. Insurance ⇐606(1.2, 4)

Insurer of deceased motorist's vehicle was not conventionally subrogated to claim of payees under property damage, medical pay, and accidental death provisions of policy, to owner of vehicle that collided with decedent's vehicle for property damage, and two occupants of colliding vehicle in personal injury settlements where its policy contained no subrogation agreements and there was no allocation or proof that requirements for conventional subrogation had been met. LSA-C.C. arts. 1827, 1828.

12. **Insurance** 🔑606(1)

Insurer of decedent's vehicle was legally subrogated to claims of its insured for payments it made under policy and thus could recover amounts paid to insureds, but could not recover amounts it paid to other individuals, who were not made part of litigation, as result of accident, e.g., owners and occupants of vehicle with which insured's vehicle collided. LSA-C.C. art. 1829(3).

Charles A. Verderame, Giraud, Cusimano & Verderame, New Orleans, for appellee/cross appellant Donald J. Hellmers.

Law Offices of James J. Morse, Ronald K. Gurley, Jones, Walker, Waechter, Poitevent, Carrere & Denegre, John C. Combe, Jr., New Orleans, for The Travelers Indem. Co.

Norman L. Sisson, Sharon F. Lyles, William J. Doran, Jr., Frank J. Gremillion, Baton Rouge, for The State of La., Dept. of Transp. and Development.

Michael D. Carbo, Adams & Reese, New Orleans, for Liberty Mut.

Before BARRY, KLEES and LOBRANO, JJ.

KLEES, Judge.

This appeal stems from a suit by Donald J. Hellmers, Jr. against the Louisiana Department of Transportation and Development [hereinafter "DOTD"] and its insurer alleging that the negligence of DOTD caused the automobile accident which killed Hellmers' wife and injured their two minor sons. The district court awarded plaintiff $1,022,523.53 in damages against the two defendants in solido.

On April 20, 1983, at approximately 2:30 p.m., Phyllis Hellmers was driving from Slidell to New Orleans in the southbound lane of Louisiana Highway 11 when she was suddenly confronted with a line of stopped cars in her lane of traffic. Attempting to avoid a collision, Mrs. Hellmers swerved into the opposite lane of the two-lane highway and was hit by an oncoming car. The accident resulted in the death of Mrs. Hellmers and serious injury to her two-year old twin sons, who were passengers in her vehicle.

The obstruction that Mrs. Hellmers was attempting to avoid was caused by a DOTD truck parked on the southdraw of a bridge and totally blocking the southbound lane of Highway 11. The truck was there for the purpose of allowing DOTD employees to do some maintenance work under the bridge.

Following the accident, plaintiff Hellmers sued DOTD on behalf of himself and his three minor children; he later amended his petition to add as a defendant Travelers Indemnity Company, the insurer of the DOTD truck. Travelers claimed that its policy did not afford coverage because the accident did not result from "the ownership maintenance, or use" of the DOTD truck. DOTD and Travelers denied all liability to plaintiff on the grounds that the sole cause of the accident was the negligence of Mrs. Hellmers. Defendants also named as a third party defendant Liberty Mutual Insurance Company, the insurer of the Hellmers' vehicle, from which they sought indemnity. Liberty Mutual then reconvened against Travelers and DOTD for payments it had made to plaintiff and others under its insurance policy.

The district judge referred the case to a Commissioner pursuant to LSA-R.S. 13:1171. After hearing the testimony, the Commissioner filed a thirteen-page report in which he made the following findings: (1) The proximate cause of the accident was negligence of DOTD in failing to adequately warn drivers of the traffic obstruction ahead, specifically DOTD's failure to implement the traffic control procedures that were required by the DOTD Maintenance and Traffic Control Handbook as absolute minimum safety standards; (2) At the time of the accident, the DOTD truck was "in use" so as to afford coverage under the

Travelers policy; (3) Driver error on the part of Mrs. Hellmers was a contributing cause of the accident; (4) The percentage of fault attributable to DOTD was 85% and that attributable to Mrs. Hellmers was 15%. The Commissioner then assessed damages as follows:

Melanie Hellmers (minor child) —		
Loss of love, affection and companionship		$225,000.00
Brian Hellmers (minor child) —		
Loss of love, affection and companionship	$225,000.00	
Personal injuries — pain and suffering	$ 10,000.00	
Total		$235,000.00
Kevin Hellmers (minor child) —		
Loss of love, affection and companionship	$225,000.00	
Personal injuries — pain and suffering	$ 15,000.00	
Total		$240,000.00
Donald Hellmers —		
Loss of love, affection and companionship	$325,000.00	
Loss of wife's earnings/services	$150,000.00	
Medical bills (Phyllis Hellmers)	$ 24,000.23	
Medical bills (Brian Hellmers)	$ 8,878.40	
Medical bills (Kevin Hellmers)	$ 9,572.85	
Funeral bills	$ 3,164.43	
Total		$520,615.91
Total Damages		$1,220,615.91

The Commissioner then reduced this figure by 15% to account for the negligence of Phyllis Hellmers and subtracted $15,000.00, which amount had already been paid plaintiff by his insurer, Liberty Mutual, making the final award to plaintiff the sum of $1,022,523.53. In addition, the Commissioner found in favor of Liberty Mutual on its reconventional demand against DOTD and Travelers, awarding Liberty Mutual the sum of $54,304.12, which figure represented 85% of the amounts it had paid to plaintiff and to the owner and occupants of the other vehicle involved in the collision.

The parties filed exceptions to the Commissioner's report in the district court. After hearing arguments on the exceptions, the court took the matter under advisement. On March 21, 1986, the district court rendered a judgment confirming the Commissioner's decision. The court's judgment was later amended as to form only. From this judgment, all parties have appealed.

In reviewing the record on appeal, we must apply the "manifest error" standard—that is, we must give great weight to the factual conclusions of the trier of fact and accept reasonable evaluations of credibility and reasonable inferences of fact made by him; we are not free to substitute our own evaluations and inferences even though they might be as reasonable. *Canter v. Koehring Co.*, 283 So.2d 716 (La.1973). Applying this standard, we can find no manifest error in the district court's judgment in favor of plaintiff. However, we do find that the judge erred with regard to the award to Liberty Mutual, and will therefore modify that award.

As the issues in this case are diverse, we will discuss each in turn.

I. *The Apportionment of Fault*

The court's finding that DOTD was 85% at fault and Mrs. Hellmers was 15% at fault is clearly reasonable in light of the evidence. As the Commissioner stated in his report, the actions of the DOTD employees represented much more than a mere slight deviation from proper traffic control procedures; rather, they exhibited a total failure to follow even the minimum safety standards required by DOTD's own manual. Both plaintiff's and defendants' experts agreed that the appropriate signing and warning requirements for the situation presented were set forth on page 19 of the DOTD Maintenance and Traffic Control Handbook. This handbook required that warning signs be placed at 1600 feet, 1100 feet, and 600 feet in advance of the obstruction. Despite this fact, no warning signs were used, and the DOTD employees who performed the work testified that they didn't even carry such signs in their truck. Neither of the two employees had ever received any training in directing or controlling traffic, flagging traffic, or safely blocking lanes of traffic. Moreover, the supervisor of these two employees, who was responsible for training them, had never received any training himself and had never even seen a copy of the Traffic Control Handbook. The only warning given to motorists was the placement of cones by the two employees in a manner that was not necessarily consistent with the pattern shown in the handbook. The DOTD employees testified that the light on top of their truck was turned on as a warning signal, but none of the witnesses to the accident could remember the light being on. Whereas the handbook requires two flagmen, the employees testified that one of them was working under the bridge while the other remained on top and acted as a flagman. The flagman, who was attempting to control traffic from both directions, stated that he did not attempt to flag Mrs. Hellmers' vehicle and in fact, did not even know a collision had occurred until another motorist told him.

[1] In view of this evidence, we find that DOTD's high duty to warn motorists of the risk which DOTD itself had created, as well as the extreme deviation of the DOTD employees from the required standard of care, justifies the assignment of 85% of the fault to DOTD. If any of the appropriate safety measures, such as signs, proper flagging procedure, or proper placement of cones, had been implemented, this accident might have been avoided. See *Forest v. State, the Louisiana Dept. of Trans. & Development* 493 So.2d 563 (La. 1986).

[2] We further find that the assignment of 15% fault to Mrs. Hellmers is reasonable. Plaintiff argues that comparative negligence should not apply to this case because DOTD's duty of care included the obligation to protect motorists even from their own carelessness. We disagree. Although DOTD had a high duty of care, it was not so high that Mrs. Hellmers' own negligence should be completely ignored. The court assigned 15% fault to Mrs. Hellmers because, despite the gross failure of DOTD to properly warn motorists, other drivers were able to stop their vehicles safely. Defendants argue that 15% does not adequately account for Mrs. Hellmers' inattentiveness and reckless driving. We disagree. There was no evidence that Mrs. Hellmers was speeding. Moreover, the evidence shows that she did not have the benefit of a flagman, which the drivers of the stopped vehicles might have had. Under the circumstances, we find the apportionment of fault to be appropriate.

[3] Finally, plaintiff argues that if the award is to be reduced by 15%, the reduction should not apply to the amount ($25,000) representing the pain and suffering of his two minor sons because these damages are not derivative of the wrongful death of his wife. This argument is without merit. Under the comparative negligence law, if defendants are only 85% at fault, they can be required to pay no more than 85% of the damages of any injured person, even a guest passenger. The remaining 15% of fault is attributable to Mrs. Hellmers. If plaintiff had sued Liberty Mutual, his own insurer, on behalf of his children, he could have recovered from it the remainder of the damages suffered by his sons. As plaintiff chose not to do this, he cannot recover this amount.

II. Coverage under the Travelers' Policy

Travelers urges, as it did in the court below, that there is no coverage under its policy for this incident because the DOTD truck was not "in use" at the time of the accident. The most recent Supreme Court decision interpreting the policy language in question here is *Carter v. City Parish Government of East Baton Rouge*, 423 So.2d 1080 (La.1982). In that case, the Court stated:

> The arising-out-of use provision is designed to limit coverage to liability resulting from conduct of the insured which constitutes both a use of the vehicle and a legal cause of the injury. Accordingly, we believe that the limitation requires a court to answer two separate questions: (1) was the conduct of the insured of which the plaintiff complains a legal cause of the injury? (2) was it a use of the automobile?

Carter, supra at 1087. In *Carter*, the Court went on to conclude that the drowning of defendant's ten-year old passenger arose out of the use of defendant's vehicle, which he had negligently driven into a body of water.

[4] In the instant case, the conduct of which plaintiff complains is DOTD's obstruction of the path of Mrs. Hellmers' vehicle and its negligent failure to warn of such obstruction. There is no question that this conduct was a legal cause of the accident, thus satisfying the Supreme court's first inquiry. Travelers claims, however, that such conduct did not constitute a use of the vehicle (the DOTD truck). We disagree. The truck was being used both to block the highway and as a part of the warning system, however inadequate, implemented by the DOTD employees. The employees testified that the truck's engine and light were left on and that they kept various tools they might need in the truck. Several DOTD officials testified that it was normal for the truck to be used in this manner. Therefore, we find that the DOTD truck was "in use" at the time of the accident so as to afford coverage under the Travelers policy.

III. Quantum

[5, 6] Defendants contend that the amount of general damages awarded plaintiff was excessive and cite numerous cases to support this contention. Plaintiff also cites cases in support of his claim that the award was justified. In reviewing this issue, we are mindful of the Supreme Court's admonition that before we can consider prior awards, we must first look at the individual circumstances of this case and determine that the trier of fact abused its "much discretion" in awarding damages. *Reck v. Stevens*, 373 So.2d 498 (La.1979). Considering the evidence, we find no such abuse of discretion in this case. The $25,000 assessed for the pain and suffering of plaintiff's twin sons is reasonable considering that they had surgery, spent nearly two weeks in the hospital, had residual abdominal pain for six to eight months, and one twin had a permanent scar on his forehead. The amounts awarded plaintiff and his children for the loss of his wife, although high, are not beyond the court's discretion. Mrs. Hellmers was thirty years old at the time of her death. Unquestionably, the Hellmers had a good marriage and Mrs. Hellmers was a devoted mother to her three young children. She also had many other talents and hobbies, such as painting, sculpture, pottery-making and gardening. Just prior to her death, she had reapplied for the position at the Louisiana Office of Employment Security which she had held before the birth of the twins. The Hellmers were also planning to build a new home, for which they had purchased a lot and had initial blueprints drawn. In view of these facts, we do not believe that the court's award of general damages was an abuse of discretion, and therefore we will not disturb that award.

IV. Interest Award

[7] The judgment appealed from awards "All amounts together with judicial interest from the date of judicial demand until paid and all costs of these proceedings." Travelers first complains that the date of judicial demand should be February 13, 1984, the date that plaintiff added Travelers as a defendant, rather than June 3, 1983, the date that plaintiff filed his petition against DOTD. This argument has no merit. Because Travelers and its insured DOTD are solidarily liable, the date of judicial demand for purposes of calculating the interest award is the date DOTD was sued.

See La.Rev.Stat.Ann. 13:4203; *Probst v. Wroten*, 433 So.2d 734 (La.App.5th Cir. 1982).

[8] Travelers also challenges the court's award of interest on the entire amount of the judgment, claiming that Travelers should not be liable for interest on any amount beyond its $1,000,000 policy limits. There is no basis for this complaint. The judgment correctly assesses interest on the entire award against both defendants in solido. It is not the function of the trial court to apportion the award between solidary defendants. If for some reason DOTD does not pay its share and Travelers is forced to pay plaintiff more than its policy dictates, Travelers would presumably have recourse against DOTD for the excess.

V. Limitation of Liability

[9] In this respect, defendants argue that R.S. 13:5106, which limits general damages against the state of Louisiana to $500,000, applies in this case. We do not believe that this statute, which became effective on September 6, 1985, after the Commissioner rendered his decision and more than two years after the accident occurred, should be applied retroactively in this case. Moreover, as a practical matter, assuming Travelers will pay the judgment up to its policy limits, DOTD's actual responsibility will not exceed the limit set out by the statute.

VI. Third Party Claim

[10] Defendants complain that the judgment failed to award them indemnity on their third-party claim against Liberty Mutual for the personal injuries suffered by the two children who were passengers in the Hellmers vehicle. Because Mrs. Hellmers was 15% at fault, defendants argue that the trial judge should have awarded them 15% of these damages (which amounted to $25,000.00 in pain and suffering and $18,451.25 in medical expenses) from Liberty Mutual. This argument is based on faulty reasoning. The entire judgment has already been reduced by 15% to reflect the negligence of Mrs. Hellmers, Liberty Mutual's insured. The reduction of an additio al 15% would therefore constitute a win fall to defendants. The district court wa correct in denying the third-party clain

VII. Award to Liberty Mutual

Finally, defendants claim that the lowe court erred by casting them in judgmen for 85% of the sums that Liberty Mutu had paid to plaintiff and others as a resul of the accident. This award was based o Liberty Mutual's reconventional deman claiming indemnity or contribution for th following amounts: (1) Payments made t plaintiff Hellmers under the property damage, medical pay, and accidental death provisions of plaintiff's policy; (2) Payment made to Mr. Maus, the owner of the vehicl that collided with Mrs. Hellmers, for property damage under the liability provision of the Hellmers' policy; and (3) Payment made to the occupants of the Maus vehicl in personal injury settlements negotiate by Liberty Mutual. Defendants conten that no contribution is owed Liberty Mutual because Liberty Mutual was neither conventionally nor legally subrogated to th claims of the payees.

[11] We agree that Liberty Mutual wa not conventionally subrogated to thes claims, as its policy contained no subrogation agreements and there was no allegation or proof that the requirements fo conventional subrogation had been met See La.Civ.Code arts. 1827, 1828 (formerl art. 2160). With regard to legal subrogation, Civil Code article 1829 (formerly article 2161) states that subrogation take place by operation of law:

> (3) In favor of an obligor who pays a debt he owes with others or for other and who has recourse against those others as a result of the payment.

Prior cases have held that in order to come under this provision, the obligor must be solidarily liable with those on whose behalf he has paid the debt. See *Lagrue v. Murphee*, 291 So.2d 844 (La.App.4th Cir.1974), *writ denied*, 294 So.2d 829 (La.1974); *Courtney v. Harris*, 355 So.2d 1039 (La.App.4th Cir.1978). Recently, however, the

Supreme Court in *Aetna Ins. Co. v. Naquin*, 488 So.2d 950 (La.1986), decided that legal subrogation under article 2161(3) (the predecessor of article 1829(3)) does not require solidarity. Id. at 954. In that case, the Court held that Aetna, who had made payments to tenants under the property damage provisions of the landlord's homeowner's policy, could recover the amounts paid from the contractor who was responsible for the damage, even though the landlord did not join in Aetna's suit. In holding that Aetna was legally subrogated, the Court stated:

> Support for the proposition that Aetna is bound with Naquin [the contractor] can also be found in the 1984 revision of the Civil Code.... In the official comments to NA [sic] LSA-C.C. art. 1829(3), comment (d) states that, "An obligor is bound 'with' another under this article regardless of whether his obligation arises from the same act as the obligation of the other or from a different act." In this case Aetna was bound with Naquin for the damages to the tenants. Aetna was bound for a different reason than Naquin but they were bound for the same thing. It is unnecessary to examine the relationship of the parties for solidarity as we have concluded that LSA-C.C. art. 2161(3) does not require solidarity.

Id. at 954 (footnotes omitted).

[12] Following the interpretation of the Code article in *Naquin*, we find that Liberty Mutual was legally subrogated to the claims of its insured for payments it made under its policy; therefore, it can recover the amounts paid to plaintiff. However, we deny recovery of the amounts that Liberty Mutual paid to other parties as a result of the accident. We know of no theory which would allow legal subrogation in this instance. Unlike the situation in *Naquin*, these were not amounts paid by an insurer on behalf of its insured who was not responsible for the damages. Rather, they were sums which Liberty Mutual elected to pay to the owner and occupants of the Maus vehicle before any determination of liability was made. Since these persons were not a part of the litigation, there has not been any determination of the liability of either DOTD, Travelers, or Liberty Mutual with regard to them. Therefore, in making these payments, Liberty Mutual did not "pay a debt [it] owed with others or for others" in terms of article 1829(3). In the absence of legal subrogation, Liberty Mutual is not entitled to reimbursement for these amounts.

Accordingly, the award to Liberty Mutual is reduced from $54,304.12 to $15,597.50, which represents 85% of $18,350.00, the total amount Liberty Mutual paid to plaintiff under its policy. We further amend the judgment to award said amount ($15,597.50) in favor of Liberty Mutual and against the State of Louisiana, Department of Transportation and Development, and Travelers Indemnity Company in solido, thereby correcting a technical error made by the district judge in failing to cast Travelers in judgment to Liberty Mutual.

Accordingly, the judgment of the district court in favor of plaintiff Hellmers is affirmed, and the judgment in favor of Liberty Mutual, the plaintiff in reconvention, is modified to the extent we have stated and so modified, is affirmed.

MODIFIED AND AFFIRMED.

Geneva Campbell GORMLEY

v.

GRAND LODGE OF the STATE OF LOUISIANA, et al.

No. CA-5495.

Court of Appeal of Louisiana,
Fourth Circuit.

Feb. 12, 1987.

Rehearings Denied March 19, 1987.

Speaker at organizational meeting filed personal injury action following fall

TIMOTHY W. STONICH
1518 Spencer Avenue
Wilmette, IL 60091

July 6, 1987

The Honorable Daniel Rostenkowski
Chairman, House Ways & Means Committee
RHOB 2111
Washington, D.C. 20515

Re: Technical Correction Act

Dear Mr. Rostenkowski:

I believe there is a feature in the new tax law that is unintentionally penalizing children and needs to be brought to your attention for possible inclusion in the pending Technical Corrections Act.

Approximately 14 months ago my wife died of cancer after a long illness. Fortunately, during the course of her illness, she qualified for social security disability payments. Consequently, our children (ages six and four) qualify for survivors benefits. The children have no other source of direct income, and this is their only legacy from their deceased mother.

I realize that the benefits themselves, under these circumstances, are not taxable. However, the new tax law would tax the income generated on these benefits at my rate. While I fully understand the intent of the law is to avoid the transfer of income from parent to child, this is clearly not the case in this instance. In fact, however, the new law will tax my children's income, derived from a totally nonrelated source, at my higher tax rate and unfairly penalize them.

I most strongly urge you to correct this inequity in the current law. The children are young enough that the income derived from investment of their survivors benefits could be large, and it is unfair to tax them at an artificially high rate simply because their father is.

Sincerely,

Timothy W. Stonich

COMMITTEE ON THE BUDGET
CHAIRMAN
TASK FORCE ON COMMUNITY
AND NATURAL RESOURCES

COMMITTEE ON
FOREIGN AFFAIRS
CHAIRMAN
SUBCOMMITTEE ON AFRICA
INTERNATIONAL ECONOMIC POLICY
AND TRADE

CHAIRMAN
NORTHEAST MIDWEST COALITION
WHIP AT LARGE

HOWARD WOLPE
THIRD DISTRICT, MICHIGAN

Congreſs of the United States
House of Representatives
Washington, DC 20515

1535 Longworth House Office Building
Washington, DC 20515
(202) 225-5011

610 South Burdick Street
Suite 808
Kalam[illegible]o, MI 49007
(616) 385-0039

938 West Columbia Avenue
Suite B
Battle Creek, MI 49015
(616) 961-4576

316 North Capitol Avenue
Suite D1
Lansing, MI 48933
(517) 482-9386

August 13, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Dan:

Enclosed please find a letter from my constituent, Mr. Roy Pentilla, requesting an amendment to the Technical Corrections Bill to provide that taxable income of a minor under the age of 14 be taxed at child's rates if the taxable income comes from a trust created before January 1, 1987.

I agree with Mr. Pentilla that parents who have established trusts for their children before the effective date of the Tax Reform Act should not suddenly find themselves taxed at the maximum rate. I urge your committee to consider Mr. Pentilla's proposal as it develops the Technical Corrections Act.

Thank you for your attention to this matter.

Sincerely,

Howard Wolpe

HOWARD WOLPE
Member of Congress

HW:cjc

Enclosure

THIS STATIONERY PRINTED ON PAPER MADE WITH RECYCLED FIBERS

[illegible]

Congress of the United States
House of Representatives
Washington, DC 20515

[illegible]

August 13, 1987

Mr. Roy Pentilla
2116 Quentin Ave.
Lansing, MI 48910

Dear Mr. Pentilla:

Thank you for contacting my office regarding the taxation of children's trust funds.

I agree with you that parents who have established trust funds for their children before the effective date of the Tax Reform Act should not suddenly find those trusts taxed at the highest rate. I have expressed my views to the Ways and Means Committee, and have taken the liberty of forwarding your letter to Chairman Rostenkowski. I am hopeful that the Committee will consider your proposal as it continues to develop the Technical Corrections Act.

Again, thank you for sharing your thoughts with me. Please do not hesitate to get back to me if I or members of my staff can be of assistance.

Sincerely,

Howard Wolpe
HOWARD WOLPE
Member of Congress

HW:cjc

THIS STATIONERY PRINTED ON PAPER MADE OF RECYCLED FIBERS

Roy A. Pentilla
2116 Quentin Avenue
Lansing, Michigan 48910

July 1, 1987

The Honorable Howard Wolpe
U. S. House of Representatives
Washington, D.C. 20515

Dear Honorable Wolpe:

RE: Technical Corrections Bill of 1987 - H.R. 2636

When I read an article that all my efforts to help our son by saving for his education had been thwarted by the last Internal Revenue Code (IRC) changes, I was upset. Our son is ten years old, and when his grandpa passed away he wanted his GM common stock to be used for Charlie's education. As a result, we set up the GM stock into a trust prior to the last change in the IRC and before the effective date. However, the recent changes provide that the trust income which is taxable to Charlie be taxed at our maximum rates until Charlie is 14. Clearly, we would not have set the trust up if we knew the income was going to be taxed at our maximum rates.

It is my request that the current technical Corrections Bill going through Congress be amended to provide that trusts ("Clifford") created before the tax code was amended be allowed to be taxed as before rather than retroactively applied. Specifically, the provision that the taxable income of minors under 14 be taxed at parent's marginal rates be modified to provide that taxable income of a minor under 14 be taxed at child's rates if the taxable income comes from a Clifford trust created before the effective date. If I can answer any questions, please let me know.

Sincerely,

Roy A Pentilla

Roy A. Pentilla

Section 1431.

American Leprosy Missions
One Broadway, Elmwood Park, New Jersey 07407 (201) 794-8650

John R. Sams, President
William R. Davies, Vice President
Dr. Felton Ross, Medical Director
Robert M. Bradburn, Director of Development

June 26, 1987

House Ways and Means Committee
c/o Robert J. Leonard
Chief Counsel Committee on House Ways
and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

To the Members of the House Ways and Means Committee:

We in charitable organizations depend upon charitable lead trusts to help raise funds for the various projects that we are involved in. When a consideration by the House Ways and Means Committee to appeal the charitable deduction as an offset against a generation-skipping tax on charitable lead trust, donors instead of continuing to give hold back their gifts. If we cannot continue to count upon the charitable gifts of Americans than either one, we would need to call upon government to make it a part of our taxes or two, aberrant our responsibilities in the privileges that God has given us and let those who are unable to help themselves suffer even more.

Therefore I urge you to reconsider the repeal of the charitable deduction as an offset against the generation-skipping tax on charitable lead trust.

Thank you.

Sincerely,

Richard R. Hamilton, Jr.
Vice President of Development

RRH:fh

American Bank

American National Bank
1 Robidoux Center
St. Joseph, Missouri 64501
(816) 233-2000

July 13, 1987

Robert J. Leonard, Esquire
Chief Tax Counsel
House Committee on Ways and Means
1102 Longworth
House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

As legal counsel for the Trust Department of this bank, I am writing about the proposed technical corrections legislation to the generation-skipping transfer tax. I have learned that the technical corrections would eliminate the ability to segregate trust property that is entirely exempt from generation-skipping tax from trust property that is non-exempt.

It would be extremely difficult to administer a trust that is only partially exempt from generation-skipping taxes or to deal with commingled property that is subject to different treatment for generation-skipping tax purposes.

Whatever aim the committee is trying to achieve by this, I think, is outweighed by the disadvantage of increased complexity and administrative difficulty. If revenue must be raised, let's get it raised by simpler, more straight-forward methods.

Sincerely,

Bob Thedinger

Robert S. Thedinger
Vice President and Trust Officer

LDE/15-14

BAPTIST FOUNDATION of TEXAS
2001 BRYAN • SUITE 1500 • DALLAS, TEXAS 75201-3003
214/922-0125

TERRY L. SIMMONS
VICE PRESIDENT AND
TRUST COUNSEL

July 17, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
1111 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

As I am sure you are aware, the Technical Corrections Act presently being considered by both houses of Congress contains an amendment to Section 2642 of the generation-skipping transfer tax provisions, wherein the definition of "applicable fraction" for purposes of determining the "inclusion ratio" is found. Under the Technical Corrections provision, the amounts otherwise allowed as a gift and estate tax charitable deduction would no longer be allowed as a deduction for purposes of determining the denominator of the applicable fraction. While individuals may differ as to whether or not this change is good law, I do not believe that anyone could argue that this is anything but a substantive provision. I know that you have made a clear pledge that substantive provisions would not be included in the Technical Corrections Act. I urge that you apply that pledge uniformly, and delete this substantive provision from the bill currently under consideration. If, as a matter of policy, Congress wishes to make this change, it would be more appropriately considered in future legislation of a substantive nature.

I appreciate your consideration and action on this matter.

Yours very truly,

T. L. Simmons

Terry L. Simmons

/cs

A program for Cub Scouts, Boy Scouts, and Explorers

SCOUTING/USA

National Office
BOY SCOUTS OF AMERICA
1325 Walnut Hill Lane, Irving, Texas 75038-3096
Telephone: 214-580-2000

June 29, 1987

Honorable Dan Rostenkowski
Chairman House Ways and Means Comm.
Room 2111 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Chairman Rostenkowski:

As Chairman of the House Ways and Means Committee you have pledged to not allow the Technical Corrections Act to "support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments." However, the current version of the bill would breech this pledge by repealing IRC Sec. 2642(a)(2)(B)(ii)(II).

Repealing the generation-skipping transfer tax's charitable deduction for lead trusts in the "inclusion ratio" formula would work hardship on the Boy Scouts of America. For example, your good friend Charlie Rahmberg in Peoria, IL worked hard as chairman of the Endowment Development Task Force of the National Executive Board of the BSA. Many lead trusts were created throughout the BSA as a result of his efforts.

Without the charitable deduction as part of the GSTT's "inclusion ratio" formula Charlie Rahmberg's efforts in Scouting are substantially annulled. At this moment, as attorney for the BSA's national office spearheading endowment development, I know of several lead trusts that are under consideration in Mansfield, Ohio, Bellingham, Washington, and Miami, Florida. These lead trusts, and many others in the future, would be substantially chilled or not created due to the loss of the charitable deduction in the GSTT's "inclusion ratio" formula--even though these lead trusts will benefit BSA local councils for many years.

It is illogical and unfair to not grant a charitable deduction for this type of lead trust to save GSTT. Without this deduction, if charitable lead-trusts benefit grandchildren, there is no charitable tax saving's incentive to create such a trust. With 11 years of national practice for two top national charities, I assure you that this charitable deduction is vital to the estate planning strategies of wealthy prospects.

Again, please adhere to your pledge and do not allow this substantive change to occur. Eliminate any portion of the Technical Corrections Act that would repeal or strike out IRC Sec. 2642(a)(2)(B)(ii)(II). Thank you.

Sincerely,

Dan A. L[illegible] J[illegible]
Associate Director
Finance Support Division

cc: Charles A. Rahmberg, C.L.U., Massachusetts Mutual Life Insurance Co.
Suites 504-23 Security Savings Building, 200 Northeast Adams St.
Peoria, IL 61602

CLARK UNIVERSITY
950 Main Street Worcester Massachusetts 01610-1477

Richard P. Traina, President

Telephone (617) 793-7320

July 9, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I am writing as President of Clark University to express concern over the just-released Technical Corrections Bill which, if enacted, would severely restrict the creation of Charitable Lead Trusts.

As proposed, the Technical Corrections Bill would repeal the charitable deduction in computing the generation-skipping transfer tax on lead trusts created after June 10, 1987. Removing this deduction would discourage our donors from establishing these trusts, which provide Clark with a guaranteed income over a period of years and, through the same device, provide for the donors' heirs in later years (often to cover the expenses of college education).

The Charitable Lead Trust is an important option for major donors to our University - a small, private coeducational, liberal arts institution. Our ability to maintain and improve academic standards and to provide scholarships for undergraduate study and graduate research is directly tied to our ability to raise funds. I urge you to amend the Technical Corrections Bill so that the Charitable Lead Trust is preserved as an effective giving method.

Cordially,

Richard P. Traina

RPT/lk

cc: The Honorable Joseph D. Early

Drexel University • Philadelphia, Pennsylvania 19104

Drexel
University

Office of
University Relations
(215) 895-2600

July 9, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
2111 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am writing to express my objection to the change vis a vis charitable lead trusts that would result from the passage of the Technical Corrections Bill of 1987. Specifically, this so-called "technical" change would repeal the charitable deduction in computing the generation-skipping transfer tax on lead trusts created after June 10, 1987.

Charitable lead trusts represent one of the major methods through which a donor of substantial means can make a large contribution to a university or non-profit institution. Large gifts (the kind that might be funded through a lead trust) generally comprise 90 percent of an institution's total fund-raising dollars. A key part of the appeal of the charitable lead trust has been the favorable tax treatment of gifts made in this manner under current law. The proposed change would make this giving method significantly less attractive to donors. The change in the tax treatment of charitable lead trusts would have a disproportionate effect on the total giving to charities.

The section of the Technical Corrections Act of 1987 dealing with lead trusts represents a substantive change, not a technical one. I ask that you remain true to your promise: "I will, of course, not support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

The purpose of the Technical Corrections Act of 1987 was not to dictate changes in policy. I ask that you ensure that the status of charitable lead trusts is not affected by what masks as a "technical" change.

Thank you for your interest in encouraging charitable gifts to non-profit institutions.

Sincerely,

Carolyn A Sprogell

Carolyn A. Sprogell
Associate Director
Planned Giving

slf

College of Business and Administration
College of Humanities and Social Sciences
College of Information Studies
College of Engineering • Evening College
Nesbitt College of Design Arts • College of Science

East Texas Baptist University

July 16, 1987

Honorable Dan Rostenkowski
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Rostenkowski:

I write out of concern for the generation-skipping transfer tax provisions under Chapter 13 of the Internal Revenue Code of 1986.

A substantive change has been slipped into the Technical Corrections Bill of 1987 (H.R. 2636 and S. 1350) introduced on June 10, 1987, in both houses of Congress which amends, rather than corrects, Sec. 2646(a)(2)(B) and Sec. 2642 (d)(2)(B) by deleting the language reducing the denominator of the applicable fraction by any charitable deduction allowed under Sec. 2055 or Sec. 2522 with respect to such property. As a result, neither the denominator of the applicable fraction for new trusts nor the denominator of the recomputed applicable fraction for additions to generation-skipping trusts will be reduced by otherwise allowable charitable deductions.

Reference is also made to the new Sec. 2625 which has been added to Chapter 13, and Sec. 2622 which defines "Taxable Amount."

The result of the above changes (not technical corrections of the Tax Reform Act of 1986!) is to completely abolish the savings opportunities in regard to generation-skipping transfer tax which charitable lead trusts provided under the original provisions of the Tax Reform Act of 1986. In addition, the charitable deduction will be available only for the portion of the taxable amount which is actually distributed to charity.

This proposed change is clearly more than a "correction", it is substantive. I read in the Wall Street Journal that you said, "This legislation is not intended or designed to make substantive changes to last year's act. In this regard, the staff has undergone painstaking analysis and review to help insure the technical nature of this legislation. I will, of course, not support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

I therefore, urge you to have your staff examine this area of the correction bill and keep the charitable deduction in the generation-skipping transfer tax's "inclusion ratio" formula.

As observed above, to repeal the Generation-Skipping Transfer Tax charitable deduction for lead trusts is clearly substantive and not technical. In addition, I would point out that the change is contrary to congressional policy of encouraging charitable gifts. This change, if enacted, could cost the nations private service sector (hospitals, schools, etc) billions of dollars in years to come.

I urge you to use your influence and position to keep the Technical Corrections Bill of 1987 just what its name implies, and to leave the historical position of the congress intact to encourage charitable gifts to the nations 501(C)(3) institutions.

Respectfully yours,

Harvey D. Lewis

Harvey D. Lewis

FOUNDATION OF
JEWISH PHILANTHROPIES
of the Greater Miami Jewish Federation

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Cecile Weiss
Dr. George Wise
Allan Yarkin

Joseph C. Imberman
Director

Greater Miami Jewish
Federation

Aaron Podhurst
President

Myron J. Brodie
Executive Vice President

July 14, 1987

Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
Room 2111
Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

RE: TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636)

The Foundation of Jewish Philanthropies is a charitable organization seeking to raise endowment funds to secure the future of humanitarian programs benefiting the entire Dade County community. We are writing to you to express our deep concern about a provision of the Technical Corrections Act of 1987 (H.R. 2636) that could have serious consequences for our organization. Specifically we are concerned about the proposed repeal of the charitable deduction in computing the generation-skipping transfer tax on lead trusts created after June 10, 1987. This change is substantive and significant and would create a disincentive for philanthropic gifts provided through estate planning.

The proposed change would effectively destroy our ability to raise funds through charitable lead trusts and would discourage endowment support for other philanthropic institutions throughout the country as well.

We also feel that the proposed amendment is substantive, and not technical, the type of amendment which you have said you will not support. We urge you to oppose it.

Thank you for your attention to our concern and your continuing leadership and vigilance on behalf of equitable taxation in the United States.

Sincerely,

Martin Kalb

Martin Kalb
Chairman

Sincerely,

Penny Marlin

Penny Marlin
Director

4200 Biscayne Boulevard, Miami, Florida 33137 (305) 576-4000

Arthur C. Frantzreb, Inc. / Consultant in Philanthropy
6233 Kellogg Drive / McLean Virginia 22101 / (703) 356-1266

President:
Arthur C. Frantzreb

Publisher:
Counseletter©
Personal Gift Planner©

June 27, 1987

Hon. Dan Rostenkowski, Chairman
House Ways and Means Committee
Room 2111 Rayburn Building
Washington, DC 20515

Dear Mr. Chairman:

Subject: Help! Philanthropy at the Stake.

The generation-skipping transfer tax charitable deduction for charitable lead trusts is clearly substantive and not technical and must be kept in the "inclusion ratio" formula.

You pledged not to "support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

Furthermore, the purported change is absolutely contrary to Congressional policy of encouraging charitable gifts.

Charitable gifts need all the help we can get to prevent the necessity for government to sustain our health care, educational, and social welfare organizations.

Thank you.

Respectfully,

Arthur C. Frantzreb

COMMONWEALTH OF VIRGINIA

SENATE

ELMON T GRAY
16TH SENATORIAL DISTRICT
PRINCE GEORGE SURRY AND SUSSEX COUNTIES
PART OF CHESTERFIELD COUNTY
CITIES OF COLONIAL HEIGHTS HOPEWELL
AND PETERSBURG
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BUSINESS (804) 834 2292

GENERAL ASSEMBLY BUILDING
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COMMITTEE ASSIGNMENTS
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FINANCE
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RULES

September 1, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
U. S. House of Representatives
2111 Rayburn House Office Building
Washington, D. C. 20515-1308

Dear Congressman Rostenkowski:

I am writing to urge that you seek the elimination of one provision in the Technical Corrections Bill of 1987; i.e., Section 114(f)(4)(D).

This provision would deny a charitable deduction for the charitable interests created under a charitable lead trust for purposes of the generation-skipping transfer tax.

The provision is clearly not a "technical correction." It is instead a change in transfer tax policy that was considered and rejected in connection with the development of the 1986 Tax Act.

As part of my estate plan, I have provided for a charitable lead trust that will benefit institutions that serve the public such as colleges, universities and hospitals. If the Technical Corrections provision referred to above is enacted, my plan will be impractical.

I hope that you will seek the defeat of Section 114(f)(4)(D) of the Technical Corrections Bill.

Sincerely,

Elmon T. Gray

ETG/lw

ONE JAMES CENTER, SUITE 902
RICHMOND, VIRGINIA 23219

September 1, 1987

The Hon. Dan Rostenkowski
U.S. House of Representatives
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Rostenkowski:

I am writing to urge that you seek the elimination of one provision in the Technical Corrections Bill of 1987 (i.e., Section 114(f)(4)(D)).

This provision would deny a charitable deduction for the charitable interests created under a charitable lead trust for purposes of the generation-skipping transfer tax.

This provision is clearly not a "technical correction." It is instead a change in transfer tax policy that was considered and rejected in connection with the development of the 1986 Tax Act.

As part of my estate plan I have provided for a Charitable lead trust that will benefit institutions that serve the public, such as colleges, universities and hospitals. If the Technical Corrections provision referred to above is enacted my plan will be impractical.

I hope that you will seek the defeat of Section 114(f)(4)(D) of the Technical Corrections Bill.

Very truly yours,

Horace A. Gray, III

HAG,III/m

JEROLD I. HORN
ATTORNEY AT LAW
518 JEFFERSON BANK BUILDING
PEORIA, ILLINOIS 61602

AREA CODE 309
TELEPHONE 676-2778

June 18, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I will comment about section 2611(b)(1) of the Internal Revenue Code of 1986 and the proposed technical correction to it set forth at section 114(f)(2) of the Technical Corrections Bill of 1987.

I suggest that section 2611(b)(1) is (and, even if the proposed technical correction is made, will be) confusing, misleading and, in terms of the purpose of chapter 13, probably wrong.

Old chapter 13 required explicit language to prevent a single transfer from being the subject of both a chapter 11 or 12 tax and a chapter 13 tax. See pre-Tax Reform Act of 1986 Code sections 2613(a)(4)(B) and 2613(b)(5)(B). Apparently, the draftsmen of new chapter 13 assumed that similar language was required to accomplish a similar objective. The Trust Division of the American Bankers Association ("ABA"), in a memorandum dated November 26, 1984, for the Treasury, commented critically about a proposed version:

> "9. Section 2611(b)(1) creates an exclusion from the term 'generation-skipping transfer' for
>
> > any transfer (other than a direct skip) from a trust, to the extent such transfer is subject to a tax imposed by chapter 11 or 12.
>
> If this language is given its plain meaning the tax appears to be avoided in some cases where it should be payable. Let us assume (1) A creates a trust for a child C and C's child G, (2) the trust authorizes the trustee to pay income to C or G, (3) the trust property is payable to G or G's estate at the death of C and (4) G has a power to direct the distribution of the trust property during C's life to other individuals. If G exercises his power and directs the trust property to be distributed to his wife, a transfer for gift tax (chapter 12) purposes occurs as to the remainder interest following C's death and section 2611(b)(1) would appear to apply as to the value of this interest. In terms of policy why should this transfer be exempt from the generation-skipping tax?"

Apparently in response to the asserted problem, the draftsmen of section 2611(b)(1) revised section 2611(b)(1) to cause it to apply only "with respect to a person in the 1st generation below that of the grantor."

I agree with the policy considerations that underlie the ABA comment. However, I do not agree that section 2611(b)(1) before the amendment would have produced the result that the ABA perceived. More importantly, I do not agree that section 2611(b)(1) presently produces proper results. I think that the circumstances recited in the ABA critique would have produced two transfers, not one, and, therefore, that the preamended version of section 2611(b)(1) would not have precluded the imposition of a generation-skipping tax. The first transfer would have been a generation-skipping transfer from the level of the generation of the child to the level of the generation of the grandchild. The second transfer would have been a gift for gift tax purposes from the grandchild to the grandchild's spouse. Thus analyzed, the transfer that was subject to a tax imposed by chapter 12 would have been a transfer different from, and subsequent to, the transfer that was subject to a tax imposed by chapter 13.

Based upon the foregoing, I suggest that a questionable analysis of an isolated transaction might underlie section 2611(b)(1) as it presently appears. More importantly, I believe that the amendment created problems where none clearly existed and that, as a result, section 2611(b)(1) as presently written (or as amended by the Technical Corrections Bill) threatens to produce wrong results. As presently written, section 2611(b)(1) might suggest that a single transfer at the level of a single generation (*i.e.*, other than the "1st generation below that of the [transferor]") somehow can be subject both to a tax imposed by chapter 11 or 12 and to a tax imposed by chapter 13.

I suggest that the appropriate remedy is either to restore section 2611(b)(1) to its version before the amendment described above or to repeal section 2611(b)(1) entirely. I direct your attention to the definition of "transferor" at section 2652(a) of the Code. Since subjection of a transfer to a tax imposed by chapter 11 or 12 generates a new transferor and, hence, new "skip persons" and new "non-skip persons," I suggest that a mechanism independently exists to serve a function at least similar to that which section 2611(b)(1) apparently is designed to serve. Stated differently, I suggest that if the grantor's child has a general power to appoint certain property and the property passes to the grantor's grandchild in default of the child's exercise of the power, the existence of the general power prevents the transfer from being subjected to a chapter 13 tax *even if* section 2611(b)(1) does not exist. Mechanically, the general power produces a transfer for purposes of chapter 11, the decedent (*i.e.*, the child) becomes the transferor for purposes of chapter 13, the grandchild becomes a non-skip person and the movement of the property to the grandchild is not a generation-skipping transfer.

I believe that a statement of the overall relationship between chapters 11 and 12, on the one hand, and chapter 13, on the other, is useful. Therefore, I prefer the first alternative, *i.e.*, retention of section 2611(b)(1) in a "cleaned-up" version that omits the final clause. However, the important point is that I believe that section 2611(b)(1) is seriously defective as it presently exists and that the presently proposed technical correction fails to address the problem.

Very truly yours,

Jerold I. Horn

Jerold I. Horn

Little
Company
of Mary
Hospital
FOUNDATION

July 8, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Please review the provision of the proposed Technical Corrections Act of 1987, H.R. 2636, which would repeal IRC Sec. 2642(a)(2)(B)(ii)(II), the charitable deduction allowed in the computation of the generation-skipping tax.

Tax policy in this country is a matter of public policy debate.

If the U.S. Congress intends to change the rules of the tax game, as it did in 1986, then it should go about changing the rules in a manner that encourages public discussion and debate.

By proposing to repeal an important charitable contribution deduction in the federal tax code under the guise of "technical corrections," I believe that the U.S. Congress is undermining the public support of a tax policy which this government so needs.

In addition, the history of tax policy in the United States has featured a consistent role for federal participation in private support of the independent, non-profit sector through the charitable contribution deduction. The deductions allowed for charitable lead trusts have been a major incentive for contributors to universities and hospitals in southern California, and I urge that the U.S. Congress review such a social (as well as tax) policy only in the context of tax reform, not technical corrections.

Thank you for your consideration of this appeal.

Sincerely,

RB

Ron Bitzer
Certified Financial Planner
Foundation

A support organization affiliated with
Little Company of Mary Hospital

4101 Torrance Boulevard, Torrance, California 90503-4698 (213) 540-7676

Loma Linda University

Department of Planned Giving
Loma Linda, California 92350
714/824-4553

July 7, 1987

Dan Rostenkowski, Chairman
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: Technical Corrections Act 1987 (H.R. 2636, S.1350)
- Charitable Lead Trusts

We understand that the above-captioned Bill would repeal the charitable deduction in computing the generation-skipping transfer tax (GSTT) on lead trusts created after June 10, 1987. It would do that by striking out IRC Sec. 2642(a)(2)(B)(ii)(II).

This seems to us to be a substantial change from last year's Act, discouraging an important source of support for charitable institutions. We therefore would urge you to allow the charitable deduction to remain in computing the (GSTT), Generation-skipping transfer tax.

Thank you for your attention to the above and your consideration of the benefits rendered by charitable entities to society and the support needed to sustain them.

Sincerely yours,

George Carambot
Director, Planned Giving

GC/ly

THE LUTHERAN CHURCH–MISSOURI SYNOD

1145 South Barr Street
Ft. Wayne, Indiana 46802-3180
219 423-1511

Rev. D.D. Schiebinger, PhD
Planned Giving Counselor
Indiana District

MEMORANDUM

Date: July 15, 1987

To: Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee

From: Dr. D. D. Schiebinger

Re: "Technical" Change in Technical Correction Act

The "technical" change in the Technical Corrections Act would, if enacted, discourage the creation of many Charitable Lead Trusts. If enacted, it would repeal the charitable deduction in computing the Generation-Skipping Transfer Tax (G.S.T.T.) on lead trusts created after June 10, 1987. If enacted, it would discourage an important source of support for charitable institutions.

I strongly encourage you to keep the charitable deduction in the G.S.T.T.'s "inclusion ratio" formula. The repeal of the G.S.T.T. charitable deduction for lead trust is clearly substantive and not technical. I strongly protest the repeal of the charitable deduction as an offset against the Generation-Skipping Transfer Tax on charitable lead trusts.

I respectfully remind you of your pledge not to "support any substantive changes to the 1986 act couched in the form of purportedly technical amendments." In addition to being substantive, the change is contrary to congressional policy of encouraging charitable gifts.

Mid-America Union
CONFERENCE OF SEVENTH DAY ADVENTISTS

8550 PIONEERS BLVD.
P. O. BOX 6128
LINCOLN, NEBRASKA 68506
(402) 483-4451

June 30, 1987

The Honorable Dan Rostenkowski
Chairman House Ways and Means Committee
Room 2111, Rayburn House Office Building
Washington, DC 20515

Good morning! Sir,

I'm very concerned about the news indicating that the House Ways and Means Committee is looking favorably at a proposal that after June 10, 1987 will reduce the charitable deduction on Charitable Lead Trusts that transfer the funds to the grandchildren. It appears to me that this is a substantial change rather than a technical amendment to the 1986 Act. I appeal to you to keep the charitable deduction in GSTT's "inclusion ratio" formula.

We have many donors that would like to benefit our college and academies with current funds as a part of their estate planning, and the Charitable Lead Trust is one of the finest ways we have of securing present funding for our school needs. And with the heavy financial pressures placed on academic expenses by rising costs, we need all the help we can get in maintaining Christian education in the private sector.

Thank you for giving this your serious attention.

Sincerely yours in Christ's service,

George Woodruff

George Woodruff, Director
Trust Services

GW/mw

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July 16, 1987

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
United States House of
Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Re: Comments on Section 114(f)(4)(C) Technical Corrections Bill of 1987 Relating to Generation Skipping Taxes

Dear Sir:

I am pleased to submit the following comments on the Technical Corrections Bill of 1987. These comments are my own personal views and do not express the views of my Firm or of the American Bar Association Tax Section of which I am a member.

My basic comment is that I believe Section 114(f)(4)(C) of the Technical Corrections Bill (the "Bill") amending Section 2642(a)(2)(B) of the 1986 Code is inappropriate and should not be included in the Bill because it is (1) substantively incorrect, (2) a substantive and not a technical change, and (3) a change that would be unfair to taxpayers if applied at this time.

Section 114(f)(4)(C) of the Bill eliminates the consideration of charitable transfers in calculating the inclusion ratio for purposes of the generation skipping tax. Under the 1986 Code, if a taxpayer created a $3,000,000 charitable lead trust that paid an annuity to charity for twenty years and then passed to his grandchildren, and if the present value under the Treasury's tables of the charitable annuity was $2,000,000, leaving a portion subject to gift or estate tax of $1,000,000, and the taxpayer applied his $1,000,000 generation skipping tax exemption to the trust, the inclusion ratio would be zero and the trust would be free of generation skipping tax upon distribution to grandchildren. In contrast, under the amendment made by Section 114(f)(4)(C) of the Bill, the inclusion ratio for the above trust would 67% and the trust would be subject to a 33% generation skipping tax upon distribution to grandchildren. This proposed result is substantively inappropriate.

If the valuation tables employed by the Treasury accurately reflect the use of money and the growth of funds, then the financial effect for charity and for grandchildren of establishing the one trust in my example would be exactly the same as establishing a $2,000,000 trust which paid the same annuity to charity and a $1,000,000 trust that accumulated funds for the family for 20 years. At the end of 20 years, this alternative disposition would provide exactly the same amount for distribution to grandchildren. However, under the proposed change, this alternative disposition would allow all of those funds to pass to the grandchildren free of generation skipping tax whereas the use of a single trust would subject the same funds to a 33% tax. The use of the single charitable lead trust provides additional security for charity, in that the family bears the risk that the returns assumed by the Treasury's tables will not be met. A family employing such a single trust should not be penalized so substantially from a family who sets up two separate trusts and puts charity at additional risk.

The absurdity of the proposed change is even more apparent should the funds not yield the rate assumed by the Treasury tables, which, considering the Treasury's failure to lower the 10% tables in light of lower interest rates, is certainly a significant risk. In that case, there will be less available for the grandchildren if a single charitable lead trust is employed than if two separate trusts are used. However, the proposed change would subject those reduced funds to the same 33% tax even though greater funds would have been available by the use of two trusts and without a tax. These two examples show that the proposed change is inappropriate, substantively incorrect and poor policy.

Apart from the wisdom of the provision, it is clear that it constitutes a very important substantive change to the statute and not a technical revision. When the generation skipping tax was proposed to tax practitioners and discussed with members of Treasury, a charitable deduction along the lines of the 1986 Act was contemplated. The technical workings of the statute along these lines were part of the overall plan which tax practitioners found acceptable as an alternative to the pre-1986 statute. Thus, it cannot be argued that this was a technical error in the Bill which no one could have anticipated and which must be corrected at this time. On the contrary, this is clearly a substantive change which should not be included in a technical corrections bill and adopted without the close scrutiny and discussion that should precede substantive revisions.

Finally, to make this change at this time without an opportunity for study and without transition rules would be unfair to taxpayers. Many taxpayers have spent significant time, effort and expense to revise estate plans to comply with the 1986 Code as it took effect on January 1. Many of these plans would be substantially affected by the change proposed in Section 114(f)(4)(C); revisions to these estate plans in light of the change will take significant time and effort to accomplish. At a minimum, any such change should have an effective date which provides ample opportunity for making such revisions.

I hope the above comments are helpful. Should you or any members of your staff wish to discuss these comments with me further, please feel free to contact me.

Yours truly,

Francis J. Mirabello

Francis J. Mirabello

THE MOUNT SINAI MEDICAL CENTER
ONE GUSTAVE L. LEVY PLACE • NEW YORK, N.Y. 10029

Mount Sinai School of Medicine • The Mount Sinai Hospital

Office of Development

(212) 650-6976

June 30th, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

In the strongest terms possible, I wish to protest the proposed loss of the charitable deduction as an offset against the generation-skipping tax on Charitable Lead Trusts.

Such trusts are not so much for the advantage of the rich as they are for the benefit of the poor. The true beneficiaries of Charitable Lead Trusts are the recipients of services who would otherwise suffer from want. Lead trust funding is crucial to Mount Sinai Medical Center and its programs in the Spanish Harlem Community. Additionally, lead funding provides the nation with world class research and superior medical care here at Mount Sinai.

Please pass on to the appropriate Representatives our dismay over the proposed changes. Simply stated, the loss of this deduction will be a terrible blow to lead trust funding.

Sincerely,

Blair Hearth

Blair Hearth
Director of Planned Giving
Mount Sinai Medical Center

BH:mib
cc: Ritchie Geisel

NORTHFIELD MOUNT HERMON SCHOOL
1879

Northfield, Massachusetts 01360
Revell Hall

July 10, 1987

The Honorable Dan Rostenkowski
Chairman House Ways and Means Committee
Room 2111 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Rostenkowski:

As a private educational institution that is partly dependent upon voluntary gifts from our constituents, we are protesting the removal of the charitable deduction from the formula used to calculate the generation-skipping tax on charitable lead trusts.

This is not a technical correction; rather, it is a substantive change which will have a decidedly detrimental effect on charitable giving.

Please amend the Technical Corrections Act of 1987 to re-include the charitable deduction in this formula.

Sincerely,

Rich Odell

Richard F. Odell
Director of External Affairs

kg

413 498 5311

GRAY, HARRIS & ROBINSON
PROFESSIONAL ASSOCIATION
ATTORNEYS AT LAW

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July 6, 1987

FEDERAL EXPRESSED

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987 (H.R. 2636) Generation Skipping Provisions - Prohibition Against Multiple Trusts

Dear Sir:

According to the general explanation of the Tax Reform Act of 1986 by the Joint Committee on Taxation, the purpose of the three transfer taxes (gift, estate tax, and generation skipping) is

> not only to raise revenue but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequenses do not vary widely depending on whether property is transferred outright to immediately succeeding generations, or it is transferred in ways that skip generations.... The Act accomplishes Congress' goal of simplified administration while insuring that transfers having a similar substantial effect will be subject to tax in a similar manner.

The prohibition against multiple trusts contained in Section 114(f)(14) of the Bill providing that a single trust may not be treated as two separate trusts for purposes of generation skipping transfer tax defeats that purpose as well as increases the complexity of the administration of the tax.

Because trusts which have over $5,000.00 in income are taxed at the highest marginal income tax rates, there are no longer any significant income tax benefits for separate trusts.

Further, the income tax code prohibits the use of multiple trusts to avoid income taxes, so the use of multiple trust for these purposes should not be a concern.

Attached is an illustration of the effect of the denial of the use of multiple trusts in the contest of the generation skipping tax. As you can see by the illustration, the prohibition against the use of separate trusts penalizes the transferor if for reasons unrelated to transfer taxes he wishes to leave his estate in trust for his children and grandchildren rather than outright. The total property subject to transfer tax is greater where the trust is required to be treated as a single trust than where the transfer is made outright or where multiple trusts are permitted.

The use of multiple trusts enables the transferor to achieve the same tax result he would achieve with outright transfers and greatly simplifies the administration of the trust.

The use of a single trust results in the transferor's generation skipping tax exemption being wasted on transfers to nonskip persons. Since the transfer tax (the estate tax) has already been imposed on these transfers to nonskip persons, no transfer tax is being avoided.

Thank you for your consideration of these matters.

Sincerely yours,

Pamela O. Price

Pamela O. Price

POP:gd

ILLUSTRATION

Assume $1,000,000 set apart for child and grandchildren at Transferor's death. Assume $500,000 in unused GST exemption. Assume all income distributed currently to child and there is no appreciation in assets. Assume principal remains in child's estate after distribution to child.

Situation 1	Outright distribution at Transferor's death:
$500,000	Outright to child
$500,000	In trust for child and grandchild. $500,000 GST exemption allocated here, so no GST tax on later distributions from trust.

	Transfer taxes at child's death:
$500,000	Subject to estate tax in child's estate.
0	No GST tax to Trust due to GST exemption.
$500,000	Subject to transfer taxes at child's death.

Situation 2	Multiple trusts at Transferor's death:
$500,000	Trust 1 for child and grandchild. No GST exemption allocated. Inclusion Ratio 1.
$500,000	Trust 2 for child and grandchild. $500,000 GST exemption allocated. Inclusion Ratio 0.

	Transfer taxes at child's death:
$500,000	Trust 1 - subject to GST tax or, if child has a general power of appointment, subject to child's estate tax, or if $500,000 was distributed to child, subject to child's estate tax.
0	Trust 2 - Covered by GST exemption.
$500,000	Subject to transfer taxes at child's death.

Situation 3	Single Trust at Transferor's death:
$1,000,000	In Trust for child and grandchild. $500,000 in GST exemption allocated. Inclusion ratio ½. $500,000 principal distributed to child.

	Transfer taxes at child's death:
$500,000	Subject to extate tax in child's estate
$250,000	Trust subject to GST tax. ($500,000 x ½ = $250,000 (1)
$750,000	Subject to transfer taxes at child's death (2)

---

(1) Technically, $500,000 is subject to GST tax at inclusion ratio of one-half. Tax on $250,000 at inclusion ratio of 1 is same. Expressed this way for comparison purposes.

(2) This result occurs because a part of the GST exemption is lost when distributions are made to a non-skip beneficiary.

RICE UNIVERSITY
P. O. BOX 1892
HOUSTON, TEXAS 77251

VICE PRESIDENT FOR
EXTERNAL AFFAIRS

(713) 527-6090

June 29, 1987

Mr. Robert J. Leonard
Chief Counsel
Committe on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This is a request for your assistance as Chief Counsel of the House Ways and Means Committee to keep the charitable deduction in the generation-skipping transfer tax (GS77) "inclusion ratio" formula for charitable lead trusts.

The new Technical Corrections Act would repeal this charitable deduction and, if this is done, it would be clearly substantive and not technical. Also, this proposed change is contrary to congressional policy of encouraging charitable gifts.

We hope that your leadership will ensure that the charitable deduction is kept as an offset against the generation-skipping tax on charitable lead trusts. Thank you for your consideration and assistance.

Sincerely,

Kent E. Dove

Kent E. Dove

KED:dww

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Our common stake in the future

Department of Planned Giving and Special Gifts
Rutgers University Foundation
192 College Avenue
New Brunswick, New Jersey 08903
201/932-8808

June 30, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Attention House Ways and Means Committee:

I am writing to protest the repeal of the charitable deduction as an offset against the generation-skipping tax on charitable lead trusts.

The repeal of this important deduction would clearly be a substantive change in the new tax law. It was my understanding that the Technical Corrections Act was not supposed to make substantive changes of any kind.

It would also be bad policy, as it would unnecessarily discourage a potentially important source of support for Rutgers University, and other nonprofit institutions.

Please do not allow this deduction to be eliminated.

Thank you.

Sincerely,

David G. Clough

David G. Clough
Director of Planned Giving
The Rutgers University Foundation

14

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HEADQUARTERS FOR THE EASTERN MICHIGAN DIVISION
TELEPHONE: (313) 961-2292
601 BAGLEY AVENUE
DETROIT, MICHIGAN 48226

July 7, 1987

Honorable Dan Rostenkowski
Chairman House Ways and Means Committee
Room 2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski,

I'm writing to ask you to retain the charitable deduction in the generation-skipping transfer tax's "inclusion ratio" formula, as you prepare the technical corrections amendments to the 1986 Tax Reform Act.

Repealing the GSTT charitable deduction for lead trusts is clearly substantive and not simply a technical correction. I remind you of your pledge not to "support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments." I would like to point out that in addition to being substantive, the change is contrary to Congressional policy which encourages charitable gifts.

Thank you for your consideration in this matter.

Sincerely,

John G. Fike

John G. Fike, CFRE
Director of Planned Giving

JGF:set

MEMBER AGENCY

SCHOOL OF THEOLOGY AT CLAREMONT

July 10, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
Room 211, Rayburn House Office Building
Washington, D. C. 20515

Dear Representative Rostenkowski:

I am writing regarding the technical corrections bill and would like to encourage you to keep the charitable deduction in the generation-skipping transfer tax "inclusion ratio" formula.

Repealing the generation-skipping transfer tax charitable deduction for lead trusts is clearly substantive and not technical. I understand you have made a pledge not to support any substantive changes to the 1986 act.

In addition to being substantive, the change is contrary to congressional policy of encouraging charitable gifts.

Once again, thank you for your fine leadership and your attention to this matter of importance.

Sincerely,

David H. Nienas

David H. Nienas
Director of Planned Giving

DHN:kd

CLAREMONT, CALIFORNIA 91711-3199 ☐ 714 / 626-3521

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DEBBIE KRAMER GREGG

July 8, 1987

FEDERAL EXPRESS

Robert Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comment on Technical Corrections Bill

Dear Mr. Leonard:

The purpose of this letter is to comment on one aspect of the proposed Technical Corrections Bill of 1987 (H.R. 2636) (the "Bill") pertaining to the generation-skipping transfer tax.

Chapter 13 of the Internal Revenue Code, as modified by the Tax Reform Act of 1986, imposes the generation-skipping transfer tax on certain "taxable terminations" and "direct skips", as defined in Code sections 2612(a) and 2612(c), respectively. An ambiguity is present under existing law because a single transfer may be both a taxable termination and a direct skip. For example, assume that spouse A creates a testamentary QTIP trust for the benefit of spouse B (i.e., a trust which qualifies for the federal estate tax marital deduction on spouse A's death by reason of an election under Code section 2056(b)(7)). Assume that no election is made under Code section 2652(a)(3) to treat the property in the trust, for purposes of Chapter 13, as if the QTIP election had not been made under Code section 2056(b)(7). Assume further that on the subsequent death of spouse B, the property in the QTIP trust is to bypass the child of spouses A and B and is instead to be held in further trust for the benefit of the grandchild of spouses A and B. Also assume that since no individual other than the grandchild has an "interest" (as defined in Code section

2652(c)) in the trust, the trust for the benefit of the grandchild is a "skip person" within the meaning of Code section 2613(a).

In the foregoing example, the subsequent death of spouse B constitutes both a taxable termination and a direct skip under current law. It is a taxable termination because the interest of spouse B in the trust has terminated and neither of the exclusions set forth in Code sections 2612(a)(1)(A) and 2612(a)(1)(B) applies. It is a direct skip because it is a transfer, subject to the estate tax, of an interest in property to a trust which falls within the definition of a skip person.

Section 114(f)(3) of the Bill seeks to solve this problem by adding a new paragraph to the end of section 2612(a) directing that the term "taxable termination" shall not include any transfer which is a direct skip. Accordingly, in the above example treatment as a direct skip would take precedence over treatment as a taxable termination. This result is sensible and has much to commend it.

However, the proposed technical correction is, I believe, deficient in one respect in that it fails to provide a remedy in one specific case. If we vary the above example so that the child of spouses A and B who is the grandchild's parent is deceased at the time of spouse B's death, a technical problem is presented which would lead to the unintended result of the transaction's being treated as a taxable termination. This problem relates to the exception set forth in Code section 2612(c)(2). Under this exception, for purposes of determining whether a direct skip has occurred, a grandchild will be deemed to move up one generation level if his parent who is a lineal descendant of the transferor (or his spouse or former spouse) is dead. Accordingly, if in our example the child of spouses A and B had predeceased spouse B, no direct skip would occur upon spouse B's death when the property passes to or in trust for the grandchild. This exception is necessary to avoid the harsh and unfair result which would occur where a transfer is made to a grandchild not in order to avoid transfer tax at the generation level of the grandchild's parent, but rather because the parent has predeceased the transferor, leaving the grandchild as the natural recipient of the property which the grandchild's parent would have taken if living.

However, in the example cited above, even though the transfer has been excluded from the definition of a direct skip under section 2612(c)(2), it would fall within the definition of a taxable termination, and hence be subject to the generation-skipping transfer tax. This is an unfair result and one which frustrates the intent of Congress, which by creating a specific exclusion from the definition of direct skip where property is transferred to or in trust for a grandchild whose parent is deceased, has evidenced a clear intention that such transfers not be subjected to the generation-skipping transfer tax.

The proposed technical correction under which direct skips are to take precedence over taxable terminations would not cure this result. Since the transfer would not constitute a direct skip because of section 2612(c)(2), the language added by the Bill would be inapplicable and a taxable termination would occur. In fact, under the law as amended by the Bill, there would be the anomalous result that a transfer in trust for the benefit of a grandchild whose parent had died before the transfer would actually be taxed (as a taxable termination) more harshly than would have been the case had the grandchild's parent still been living at the time of the transfer in trust to the grandchild (in which case the transfer would have been taxed as a direct skip rather than a taxable termination). This is because a direct skip is, in general, taxed more favorably than a taxable termination.

It would seem that to be consistent with both the evidenced Congressional intent as well as concepts of fundamental fairness, a transfer such as the example cited above where property in a QTIP trust passes to or in trust for a grandchild on the death of the second spouse should be excluded from the definition of taxable termination entirely and should be tested solely under the direct skip provisions. Accordingly, if the transaction is excluded from being taxed as a direct skip under the predeceased child exception of section 2612(c)(2), the transaction should be entirely excluded from the tax. This should also be true in the case of any other transfer from a trust which may fit the technical definition of a taxable termination but which is also a transfer subject to the estate or gift tax of an interest in property to a skip person (for example, a situation where the grantor of a fully revocable inter vivos trust dies and where the trust corpus then passes to or in continuing trust for the grantor's grandchild).

To accomplish this, I believe that a section 114(f)(3) of the Bill should be amended to read as follows:

"(3) TAXABLE TERMINATION NOT TO INCLUDE DIRECT SKIP.--For purposes of this chapter, the term 'taxable termination' shall not include any transfer which is a direct skip or which would be a direct skip except for the application of section 2612(c)(2)."

Five additional copies of this letter are enclosed.

Very truly yours,

Ken Slutsky

Kenneth J. Slutsky

Comments to the Committee on Ways and Means, U.S. House of Representatives, on the Technical Corrections Bill of 1987, H.R. 2636

Re: Proposed amendments to Section 2642 of the
Internal Revenue Code of 1986 and enactment
of new Section 2625.

Section 114(f)(4) of the proposed Technical Corrections Act of 1987, H.R. 2636 and S. 1350 (the "Bill"), as introduced in the House of Representatives on June 10, 1987, would amend Section 2642 of the Internal Revenue Code of 1986 ("I.R.C.") by eliminating certain provisions of the present generation skipping transfer tax law. Under the Tax Reform Act of 1986 (the "1986 Tax Act"), the present value of charitable interests created under an irrevocable charitable split-interest trust is deducted from the value of property transferred to such trust in determining the inclusion ratio for generation-skipping transfer tax purposes. I.R.C. §2642(a)(2)(B)(ii) and I.R.C. §2642(d)(2)(B)(i). The Bill would delete these provisions, so that the inclusion ratios of such trusts for generation skipping transfer tax purposes would be determined in total disregard of the actuarial value of the charitable interests in such trusts. The Bill would, instead, add a new Section 2625 to the Code, which is intended to provide for a reduction in the taxable amount by the amount of any charitable deduction which would be allowable under the estate or gift tax as of the time of the generation skipping transfer.

The proposed amendments to I.R.C. §2642 are not technical corrections, but rather are substantive changes which should be considered by Congress only, if at all, in the context of future tax reform legislation. Moreover, the suggested addition of proposed I.R.C. §2625 does not provide a workable alternative means of giving proper credit for charitable interests in the computation of the generation skipping transfer tax applicable to irrevocable charitable split-interest trusts.

Under the 1986 Tax Act, gifts or bequests which create irrevocable interests in both charities and grandchildren (or other natural persons treated as "skip persons") are treated equivalently under the generation skipping tax, whether such gifts are made outright (or in separate trusts), in a charitable lead trust, or in a charitable remainder trust. The application of the present I.R.C. §2642 results in identical inclusion ratios for all three forms of gift (assuming some allocation of the Generation Skipping Transfer Tax exemption to the grandchildren's interest) as long as the actuarial values of the charitable interest and the grandchildren's interest are the same for all three forms of gift. While the amount and timing of payment of the generation skipping tax will vary among the alternative forms of giving (because they involve, respectively, a direct skip, a taxable termination, and a series of taxable distributions), the use of the Treasury's actuarial tables to compute the present value of the noncharitable interests subject to generation-skipping tax results in equivalent tax treatment.

Under the proposed changes to §2642 and the proposed addition of new §2625, this equivalent treatment of actuarially equivalent gifts will be eliminated, setting up an arbitrary distinction between different forms of giving that have long been sanctioned by the Code for federal gift and estate tax purposes. The inclusion ratio for both charitable lead trusts and charitable remainder trusts will be the same as the inclusion ratio for a trust with no charitable interests; while the inclusion ratio for an outright gift (or a separate gift in trust) to grandchildren of an amount equal to the actuarial value of the grandchildren's interest in either type of charitable trust, will result in a lower inclusion ratio (because the value of the charitable gift is not part of the computation). Not only will the two split-interest trusts be subject to a higher inclusion ratio than the outright equivalent gift to grandchildren under the proposed change, but a further and arbitrary distinction will be created between charitable lead trusts and charitable remainder trusts.

Because the generation skipping transfer in a charitable lead trust will occur at the termination of the charitable interest, no adjustment in the amount subject to tax will be made under the proposed §2625 for the interest which has already passed to charity. (This adjustment is unnecessary under the 1986 Tax Act because the charitable interest will be taken into account in computing the inclusion ratio.) However, proposed §2625 should result in a reduction of the taxable amount with a charitable remainder trust because there remains a future charitable interest at the time the generation skipping transfers occur, that is, when distributions are made to grandchildren. Indeed, it is suggested by the example given in the "Description of the Technical Corrections Act of 1987" prepared by the Staff of the Joint Committee on Taxation (the "Staff Description") at page 262 that such an adjustment will be made (although there are technical problems with the application of proposed §2625 which will be discussed below). The result will be that less tax will be payable, even after taking into account the present value of payments when due, with a charitable remainder trust than with a charitable lead trust which has identical respective values for the charitable and the grandchildren's interests in the trust. Thus, as a result of the proposed changes, three different methods by which a donor may allocate gifts between charities and grandchildren, all of which have long been treated as equivalent under the established principles of valuation found in the estate and gift tax law, will be treated entirely differently under the generation skipping tax. There is no defensible reason for such unequal treatment of charitable giving techniques which have been well established as equivalent.

In addition, the technical application of the proposed §2625 is unclear. It is not clear that the example given in the Staff Description will be treated in the manner suggested. Because a charity has an "interest" in a charitable remainder trust, within the meaning of I.R.C. §2652(c)(1)(C), no taxable termination under I.R.C. §2612(a)(1)(A) occurs upon the expiration of the child's interest in the trust in the example given. Similarly a gift to a charitable remainder trust which establishes an annuity or unitrust interest for a grandchild, with remainder to a charity, will not constitute a "direct skip" within the meaning of I.R.C. §2612(c)(1) because the trust is not a "skip person" under I.R.C. §2613(a)(2). Accordingly, in both trusts, the generation skipping tax would be imposed on the "taxable distributions" to grandchildren. It is unclear how the reduction in the "taxable amount" called for by proposed §2625 would be computed for such "taxable distributions."

The legislative history of the 1986 Tax Act provides no support for changes to I.R.C. §2642 proposed in the Bill. The provisions of the 1986 Tax Act at issue were part of the original text of H.R. 3838 reported by the House Ways and Means Committee. The provisions were subjected to the various stages of Congressional review at that time and were enacted with no apparent question or concern about their intended meaning or application. The present provisions of the 1986 Tax Act establish fair and equivalent treatment of equivalent methods of making combined transfers to grandchildren and charities, and they are consistent with established valuation and taxation principles that have long been applied to such interests under estate and gift tax law. The amendments proposed in Section 114(f)(4) of the Bill would destroy that equivalence. In addition, the attempt to make wholly unanticipated and substantive changes in the generation skipping transfer tax enacted by the 1986 Tax Act through a Technical Corrections Act is inappropriate. We urge, therefore, that Section 114(f)(4) be deleted from the Bill.

Submitted by:

Barbara J. Smith, Esq.
M. Patricia Culler, Esq.
Squire, Sanders & Dempsey
1800 Huntington Building
Cleveland, Ohio 44115

June 30th, 1987

Hon. Dan Rostenkowski
Chairman, House Ways and Means Committee
Rayburn House Office Building--Room 2111
Washington, D.C. 20515

Dear Representative Rostenkowski:

I write you today imploring you to oppose a particular amendment to the Tax Reform Act as proposed in the Technical Corrections Act of 1987. It is a change that, if enacted, would discourage a number of gifts to Southern Methodist University as well as to other charitable organizations across this country.

I speak, of course, of the proposed change that would eliminate the charitable deduction in computing the generation-skipping transfer tax on newly created lead trusts, new IRC Sec. 2625. The result of these changes is to completely abolish the tax savings opportunity in regard to the GSTT which charitable lead trusts provided under the original provisions of the Tax Reform Act of 1986. In addition, when read with IRC Sec. 2622, dealing with taxable terminations of generation-skipping transfers, we now find that the charitable deduction will be available only for the portion of the taxable amount which is actually distributed to charity.

This is a substantive change that is being proposed; it is not a technical amendment. You recently stated that you would "not support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments". In addition, this "technical change" is bad policy; it goes against Congressional policy of encouraging charitable contributions. In effect, it removes the charitable lead trust from our ever diminishing list of possible gift vehicles intended to benefit not only the donor, but the University as well.

Again, because it so clearly discourages the use of the charitable lead trust, because it obviously is a substantive change against which you have objected to so strenuously, and because it is contrary to Congressional policy of encouraging charitable gifts, I ask you to oppose this portion of the Technical Corrections Act of 1987. I ask you this on behalf of our University, as well as for many other similar institutions and organizations.

Thank you for your time and attention in this matter.

Very truly yours,

Colin V. French, J.D., LL.M.
Director of Planned Giving

OFFICE OF PLANNED GIVING / (214) 692-2681
SOUTHERN METHODIST UNIVERSITY / P.O. Box 4115, DALLAS, TEXAS 75275

Southwestern
University
AT GEORGETOWN, TEXAS

July 7, 1987

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I am writing to express opposition to a proposed provision of The Technical Corrections Act of 1987 which would eliminate the charitable deduction in computing the generation-skipping transfer tax on charitable lead trusts created after June 10, 1987.

This proposed "technical correction" would be a substantive change of the current law, and it would have the effect of a dramatic increase on the taxation of remainder interests at the end of the term of charitable lead trusts. The effect would be to discourage this important source of gift revenue for countless charities.

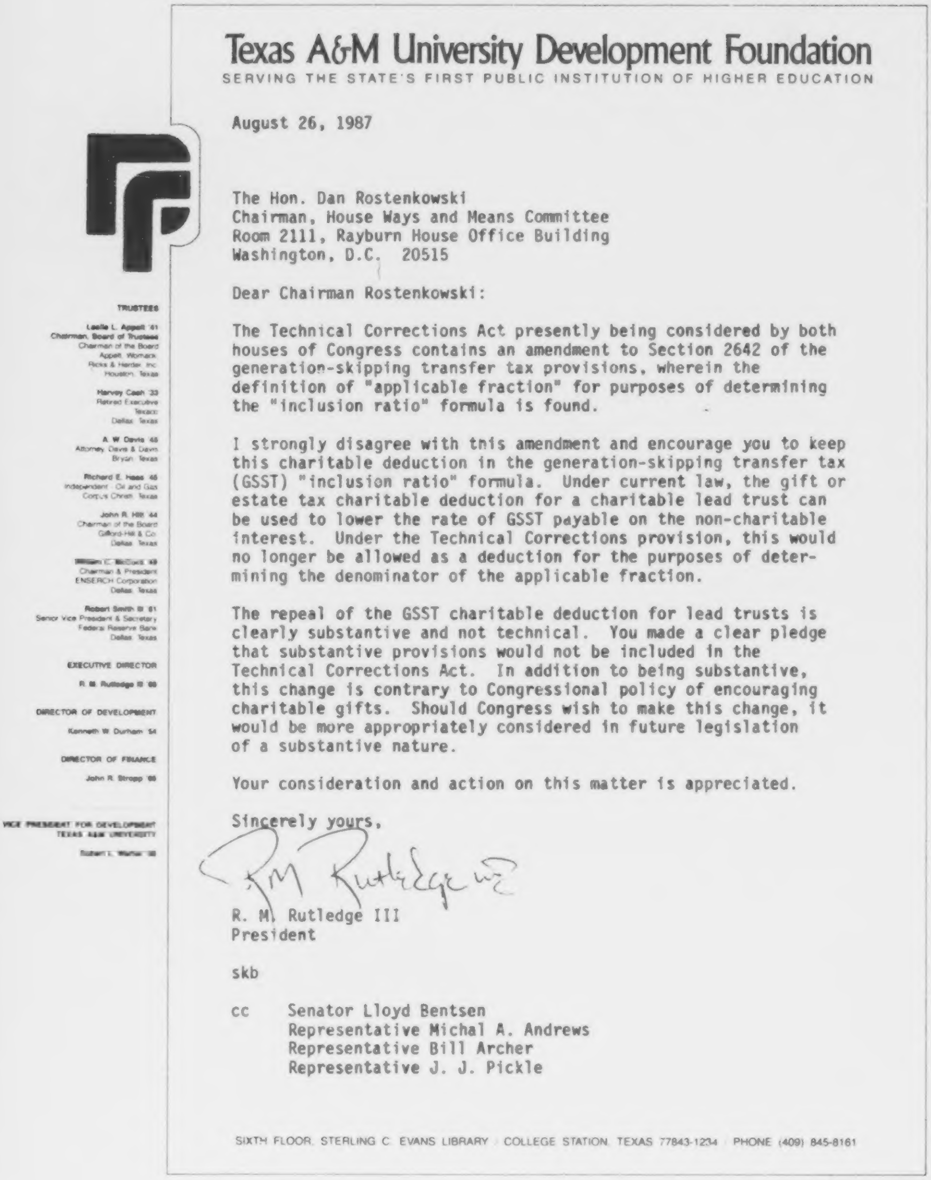
Sincerely,

Rick Eason

Richard B. Eason
Vice President for Development

RBE:jr

Georgetown, Texas 78626
512-863-6511



Texas A&M University Development Foundation
SERVING THE STATE'S FIRST PUBLIC INSTITUTION OF HIGHER EDUCATION

August 26, 1987

The Hon. Dan Rostenkowski
Chairman, House Ways and Means Committee
Room 2111, Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

The Technical Corrections Act presently being considered by both houses of Congress contains an amendment to Section 2642 of the generation-skipping transfer tax provisions, wherein the definition of "applicable fraction" for purposes of determining the "inclusion ratio" formula is found.

I strongly disagree with this amendment and encourage you to keep this charitable deduction in the generation-skipping transfer tax (GSST) "inclusion ratio" formula. Under current law, the gift or estate tax charitable deduction for a charitable lead trust can be used to lower the rate of GSST payable on the non-charitable interest. Under the Technical Corrections provision, this would no longer be allowed as a deduction for the purposes of determining the denominator of the applicable fraction.

The repeal of the GSST charitable deduction for lead trusts is clearly substantive and not technical. You made a clear pledge that substantive provisions would not be included in the Technical Corrections Act. In addition to being substantive, this change is contrary to Congressional policy of encouraging charitable gifts. Should Congress wish to make this change, it would be more appropriately considered in future legislation of a substantive nature.

Your consideration and action on this matter is appreciated.

Sincerely yours,

RM Rutledge III

R. M. Rutledge III
President

skb

cc Senator Lloyd Bentsen
Representative Michal A. Andrews
Representative Bill Archer
Representative J. J. Pickle

TRUSTEES

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VICE PRESIDENT FOR DEVELOPMENT
TEXAS A&M UNIVERSITY

[illegible]

THOMAS JEFFERSON UNIVERSITY

Office of the
Associate Director of Development

Philadelphia, 19107
(215) 928-7990

July 14, 1987

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

To Whom This May Concern:

I should like to protest the repeal of the charitable deduction as an offset against the generation-skipping tax on charitable lead trusts. Repealing the generation-skipping transfer tax charitable deduction for lead trusts is a substantive, and not a technical, change. Repealing this charitable deduction would be contrary to Congressional policy of encouraging charitable gifts.

Thank you.

Sincerely yours,

Francis J. McGovern

Francis J. McGovern
Associate Director of Development/
Director of Planned Giving

FJM/gt

AN ACADEMIC HEALTH CENTER

Jefferson Medical College
Thomas Jefferson University Hospital

College of Graduate Studies
College of Allied Health Sciences

Statement on Technical Corrections H.R. 2636
IRC Section 2642(a)(2)(B)(ii)(II)
by Richard D. Bailey, Executive Director
The United Methodist Foundation
in Western North Carolina

Summary

The Technical Correction Act (H.R. 2636) would repeal the charitable deduction in computing the generation-skipping transfer tax by striking IRC Section 2642(a)(2)(B)(ii)(II) on charitable lead trust created after June 10, 1987. This is clearly a substantive change, not a technical change, which would have a major negative effect on the nation's charitable institutions. The charitable deduction as an offset against the generation skipping tax on charitable lead trust should not be repealed.

Rationale

The creation of a charitable lead annuity trust or unitrust which makes payments to a charity for a number of years, and then the remainder goes to grandchildren, would be seriously hindered under a substantive change in the Technical Correction Act H.R. 2636. Under current law, the gift or estate tax charitable deduction for a charitable lead trust can be used together with the $1-million exemption to lower the generation skipping transfer tax due on the non-charitable interest. Technical corrections would completely eliminate the contribution deduction in computing the generation skipping tax by repealing IRC

Section 2642(a)(2)(B)(ii)(II).

The living charitable lead trust has been an important source in support of our nation's charities by donors who are willing to provide income to a designated charity for a term of years and then have the asset go to grandchildren. The gift tax charitable deduction for the current value of the income which will be distributed to charity has helped to motivate the use of lead trusts.

Generally, the lead trust has been use by the wealthy donor in support of higher education, health care, medical research and other important causes related to the quality of American life. Charities cannot afford to lose even one of these potential funding sources.

Please encourage this source of support for our nation's charities by not repealing IRC Section 2642(a)(2)(B)(ii)(II).

July 15, 1987

Today's Tax-Wise
"Gift of Tomorrow"

July 2, 1987

Representive Dan Rostenkowski
Chairman, House Ways and Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Representive Rostenkowski:

A bombshell masquerading as a "technical" change in the Technical Corrections Act would, if enacted, discourage the creation of many charitable lead trusts. (Typically a charitable lead trust makes payments to charity for a number of years, with the remainder going to grandchildren.)

I am writing today to ask you to keep the charitable deduction for charitable lead trusts in the generation-skipping transfer tax's (GSTT) "inclusion ration" formula.

Repealing the GSTT charitable deduction for lead trusts is clearly substantive, and not technical. I want to remind you of your pledge "not to support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

In addition to being substantive, the change is contrary to congressional policy of encouraging charitable gifts. Charitable lead trusts facitilated $45,000 in funding for our human services programs in this county, just last year alone!

I think it's bad policy to discourage an important, long-standing source of support for charitable institutions!

Please oppose this amendment, and keep the charitable deduction in computing GSTT on lead trusts created after June 10, 1987. Preserve IRC Sec. 2642 (a)(2)(B)(ii)(II). Thank you!

Sincerely,

Sally C. Walker

Sally C. Walker
Director, Endowment/Planned Gifts Program

cc: Robert J. Leonard (6 copies)
Tom Sneeringer
SCW:np

Committee Mr. Earl Damitz, CPA, Chairman; Mr. David C. Andre; Mr. G. Paul Didier, CFP; Mr. Silvio DiLoreto; Diane B. Doiron, CLU; Mr. Wallace T. Drew; Mr. Joseph F. Green, Esq.; Mr. Reuben J. Irvin; Mr. Jack F. Stoop
Director Ms. Sally C. Walker

United Way Endowment/Planned Giving Program
320 East Gutierrez Street, Santa Barbara, CA 93101-1707, Telephone (805) 965-8591

UNIVERSITY OF FLORIDA FOUNDATION, INC.
P.O. BOX 14425
GAINESVILLE, FLORIDA 32604

(904) 392-1691

June 30, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to express my concern to you and to the House Ways and Means Committee over the proposed substantive change which would be brought about by the proposed Technical Correction Act of 1987. Specifically, the Technical Correction Act of 1987 will completely eliminate the charitable deduction in computing the generation-skipping transfer tax on charitable lead trusts created after June 10, 1987. The Act would in effect strike out IRC Secs. 2641 and 2642(a)(2).

The charitable lead trust is and has been an important source of income for many charitable organizations, including the University of Florida. To significantly alter the charitable lead trust by repealing the charitable deduction as an offset against the generation-skipping tax would deny our institution a valuable source of endowment funding for academic enrichment programs and scholarship support for needy and meritorious students.

This change when added to the sunsetting of the non-itemizers' charitable deduction, the addition of appreciation as an Alternative Minimum Tax preference item, and the proposed change in the treatment of charitable gift annuities under IRC Sec. 501(m), will seriously harm the body of charitable organizations. Over a period of time the action of these changes will severely weaken our ability to serve the needs of our students and the individuals of this state and nation who rely upon the teaching and research generated by the University of Florida.

Sincerely,

Robert R. Lindgren
Director of University
Development

RRL/DDO/jak

UNIVERSITY OF ROCHESTER

DEVELOPMENT OFFICE

July 8, 1987

Hon. Don Rostenkowski
Chairman House Ways and
Means Committee
Room 2111 Rayburn Office Bldg.
Washington, D.C. 20515

Dear Congressman Rostenkowski:

As it stands now the Technical Corrections Act of 1987 (H.R. 2636 S. 1350) would repeal the charitable deduction in computing the generation skipping transfer tax on lead trusts created after June 10, 1987. I am writing to urge you to keep the charitable deduction in the generation skipping transfer tax's "inclusion ratio" formula.

This would be a substantive change and against the Congressional policy of encouraging charitable gifts. The current law encourages prospective donors to make gifts like a lead trust that they may otherwise not consider. Thank you for your support.

Sincerely,

Jack Kreckel

Jack Kreckel
Associate Director of
Planned Giving

JK/ajv

ROCHESTER, NEW YORK 14627 • TELEPHONE (716) 275-2041

THE UNIVERSITY OF TENNESSEE

UT

Office of the Executive Vice President
and Vice President for Development
605 Andy Holt Tower
Knoxville 37996-0166
Telephone (615) 974-2206

July 8, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, DC 20515

Dear Mr. Leonard:

On behalf of the University of Tennessee, I urge that the Ways and Means Committee reconsider the proposed change to IRS Sections 2641, 2642 (a) (2) which is contained in the technical corrections act now pending before this committee. It is important to the University of Tennessee that the current law provisions allow the inclusion of charitable contributions in calculating the Generation Skipping Transfer Tax (GSTT).

The creation of lead trusts has provided a substantial amount of support for this University and for many other charitable organizations. The proposed changes represent bad tax policy in that they will remove the incentive for these important and typically large gifts. This device has made possible benefits to organizations, like ours, while protecting the inheritance of ultimate heirs. Such a sharp reduction on top of the already substantial reductions in incentives contained in the Tax Reform Act of 1986 erodes further the ability of charitable organizations to meet their public purpose.

Further, we are convinced that the change proposed in this section of the code represents a substantive rather than a technical amendment to the act passed last year. It is the stated purpose of the Chairman that this bill be used to correct parts of the act in which technical errors have been made or the language of the act is not sufficiently clear to carry out congressional intent. We can find no basis for this change within those limits.

We appreciate the decision of the Committee to allow a period of public comment and urge your favorable consideration of these modifications.

Sincerely yours,

Joseph E. Johnson
Executive Vice President and
Vice President for Development

Identical letter received from Charles F. Brakebill, Associate Vice President for Development.

WESLEYAN UNIVERSITY
Middletown, Connecticut 06457
(203) 347-9411 x2886

Office of Planned Giving

July 6, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard,

As a planned giving officer at Wesleyan University, I am opposed to the amendment in the Technical Corrections Act which would strike out IRC SEC. 2642(a)(2)(B)(ii)(II) and thereby completely eliminate the charitable deduction in computing the generation skipping transfer tax on lead trusts created after June 10, 1987.

This proposal represents a substantive change and should not be misrepresented as merely a technical correction. According to House Ways and Means Committee Chairman, Dan Rostenkowski, the Technical Corrections Act is not intended to make substantive changes to TRA 1986.

For Wesleyan University and other not-for-profit institutions, this sweeping amendment would discourage an important source of support. While our donors are primarily motivated by a desire to benefit their alma mater or favorite charity, the added incentive of tax savings often results in larger or multiple gifts. As direct Federal aid for education has diminished, continuing government support of philanthropy, as evidenced in the Internal Revenue Code, has become increasingly important.

On behalf of all not-for-profit organizations, I urge you to reconsider the proposed amendment as discussed above on the grounds that: 1) it is clearly substantive and, 2) it will discourage an important source of support for charitable organizations.

Sincerely,

Judy Pillon

Judy Pillon
Assistant Director of Planned Giving

JPP/llh

July 8, 1987

Whitworth Foundation
Whitworth College
Spokane, WA 99251
509-466-3220

Board of Directors
Werner Rosenquist
William Bell
Harry M. Dixon
William Fix
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Martin Polhemus
Rev. Lloyd Thompson
Edward Unicume
Fred B. Utter, Jr.
Stephen Trefts
Executive Vice President

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
Unites States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

Whitworth College is a Christian liberal arts college which is celebrating its centennial anniversary in 1990. The Whitworth Foundation has been instrumental in building the College endowment fund through a successful planned giving program.

Charitable lead trusts are an important source of support for many charitable institutions which work with planned giving. We are concerned about the repeal of the charitable deduction which offsets the generation-skipping tax on charitable lead trusts. This substantive change to the 1986 Tax Reform Act through the Technical Corrections Act would strongly discourage any future charitable lead trusts and would be contrary to the policy of Congress to encourage charitable gifts.

We urge you to amend this "technical correction" to the 1986 Tax Reform Act and keep the charitable deduction in the inclusion ratio formula for the generation-skipping transfer tax.

Sincerely,

Stephen Trefts
Executive Vice President

ST:aw

SHANK, IRWIN, CONANT, LIPSHY & CASTERLINE
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TELECOPIER (214) 720-9650

JANICE J. ZABUKOVEC
DIRECT DIAL NUMBER
(214) 720-9784

July 22, 1987

Honorable Dan Rostenkowshi
Chairman House Ways & Meas Committees
Room 211 - Rayburn House Office Building
Washington, D.C. 20515

Dear Honorable Dan Rostenkowshi:

I am writing with regard to the Technical Corrections Act of 1986. As I understand the changes made by this Act, the charitable deduction in computing the generation skipping transfer tax (GSTT) would be repealed on lead trusts created after June 10, 1987. By repealing the GSTT charitable deduction for lead trusts, the Tax Committees clearly made substantive, rather than technical, changes to the Act. In addition, and probably more importantly, this change is contrary to the congressional policy of encouraging charitable gifts. Therefore, I request that you stand by your pledge not to "support" any substantive changes to the 1986 Act couched in the form of purportedly technical amendments, and to keep the charitable deduction in the GSTT's "inclusion ratio" formula.

Very truly yours,

Janice J. Zabukovec
Janice J. Zabukovec

JJZ/ke

Section 1433

WRITTEN COMMENTS
OF
RICHARD HOLLERITH, JR.
AND
ROBERTA NIELSEN FOR AMERICAN SECURITY BANK, N.A.,
CONSERVATORS OF THE ESTATE OF VIRGINIA HOLLERITH
TO THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
JULY 16, 1987

H.R. 2636
Sec. 114(g)(2)(D)
Retroactive Application of Generation-Skipping Tax
to Estate of Individual Mentally Incapacitated
Since February 1986

In accordance with the instructions set forth in the Committee's Press Release No. 12 of June 10, 1987, the following written comments are submitted to you by the conservators of the estate of Virginia Hollerith, an elderly maiden lady whose will provides for the creation of trusts for the benefit of her many nieces and nephews and their children.

Under the Internal Revenue Code of 1986 a federal estate tax will be imposed with respect to the transfer of Miss Hollerith's estate on her death, but no tax would be imposed on the ultimate transfer of income and principal to her grand nieces and nephews by reason of her mental incapacity since February of 1986, when she suffered a stroke. The proposed amendment of section 1433(b)(2)(C) of Public Law 99-514 (enacted into law October 22, 1986), specifically section 114(g)(2)(D), lines 14, 15, and 16 on page 440 of H.R. 2636, would change this result by causing a generation-skipping tax to be imposed, notwithstanding Miss Hollerith's continuous inability since before the date of enactment of the 1986 Act to change her will or otherwise dispose of her property. Ironically, the proposed amendment would impose no additional tax had Miss Hollerith died before January 1, 1987. Indeed, this would be true even if she had changed her will after September 25, 1985, the date that the proposed amendment seems to assume that this elderly lady should have become aware that Congress was contemplating enactment of a new generation-skipping tax. Moreover, the effective date provision which it is now proposed be changed remained unchanged from the date H.R. 3838 was introduced on December 3, 1985, until it became law on October 22, 1986.

We respectfully submit that it is extremely unfair for the Congress to impose transfer taxes that have any retroactive effect, and that this would be particularly true if those taxes were imposed with respect to transfers under very old wills of elderly individuals who prior to the effective date of the new law became mentally incapable of changing those wills. Indeed, it is bad enough to assume that such individuals were or should have been aware of congressional committee staff proposals which might result in the double taxation of their estates, but it would be especially egregious to impose a second tax retroactively, after those individuals were unable to change their wills and avoid the tax, except by dying before January 1, 1987, particularly when the effective date language of the new law remained unchanged from the time it was first introduced, thus leading anyone examining that language to conclude that the new tax would only be imposed prospectively.

For the reasons stated, we respectfully urge the Committee to delete the language which appears on lines 14, 15, and 16 of page 440 of H.R. 2636 as introduced in the House on June 10, 1987, and to report that bill to the House without that language.

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July 17, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to point out a problem in the drafting of the provisions of the Technical Corrections Bill (H.R. 2636) to the Tax Reform Act of 1986 relating to the $2 million exemption under the generation-skipping transfer tax, which I believe should be corrected in the final version of the Bill. Section 114(g) of the Bill, as drafted, specifies that certain requirements must be met in order for a transfer in trust to be treated as a transfer to a grandchild for purposes of the $2 million exemption under Section 1433(b)(3) of the Tax Reform Act. These requirements are that:

(i) during the life of the grandchild, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such grandchild,

(ii) the assets of the trust will be includible in the gross estate of the grandchild if the grandchild dies before the trust is terminated, and

(iii) all of the income of the trust for periods after the grandchild has attained age 21 will be distributed to such grandchild not less frequently than annually.

As you know, there is a special election under Section 1433(d) of the Tax Reform Act which makes the $2 million exemption available to certain transfers in trust made before the date of enactment which would not otherwise qualify for the exemption. Under the literal wording of the Technical Corrections Bill, the requirements set forth above may apply to transfers in trust whether made before or after the enactment of the Tax Reform Act. The application of the requirement that no amount be distributable to any other person than the grandchild during the grandchild's lifetime to pre-enactment as well as post-enactment transfers seems a reasonable means of ensuring that the trust be essentially for the benefit of a grandchild. In addition, by means of the election under Section 1433(d) of the Tax Reform Act, the property of a trust created before the enactment of the Act may be includible in a grandchild's gross estate, making compliance with the second requirement set forth above possible in the case of a pre-enactment transfer where the trust property would not otherwise be includible in the grandchild's gross estate.

However, the requirement that all of the trust income be payable to the grandchild starting at age 21 cannot be reasonably applied to pre-enactment transfers. Given the purpose of extending the benefits of the $2 million exemption to gifts in trust made at a time when no one could have foreseen what trust provisions would qualify for the exemption, it seems inappropriate to impose such a specific requirement upon pre-enactment transfers in trust. It would be a matter of sheer accident if any donor happened to have created a trust containing the age-21 mandatory income provision during that period. It is difficult to imagine any basis for making the special treatment under Section 1433(d) of the Tax Reform Act so narrowly available. Avoiding such a narrow application of the exemption seems critically important where the generation-skipping transfer tax may be retroactively applied.

Accordingly, it would seem appropriate for the election under Section 1433(d) to be available whether or not a trust contains the age-21 mandatory income provision, and the final version of the Technical Corrections Bill should make clear that the election is so available. A very simple means of accomplishing this would be to add the words "in the case of a transfer on or after October 22, 1986" at the beginning of Section 1433(b)(3)(B)(iii) of the Tax Reform Act in the final version of the Technical Corrections Bill.

Sincerely,

Mark D. Balk

MDB/kam

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July 13, 1987

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Hon. Robert J. Leonard
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Re: $2,000,000 Grandchild's Exemption from Generation-Skipping Tax -- Technical Corrections Act

Dear Sir:

We are writing this letter to inform you of concerns that we have relating to the provisions of the Technical Corrections Act dealing with the $2,000,000 exemption from generation-skipping taxes for transfers "to a grandchild". Section 114(g)(3)(B) of the proposed Technical Corrections Act provides that a transfer in trust will be treated as a transfer to a grandchild only if: (1) no portion of the corpus or income of the trust may be distributed to any person other than the grandchild during the life of the grandchild; (2) the assets of the trust will be includable in the gross estate of the grandchild if the grandchild dies before the trust terminates; and (3) all of the income of the trust for the period after the grandchild has attained age 21 will be distributed to the grandchild not less frequently than annually.

Our concerns relate to the third requirement. For the reasons set forth in the body of this letter, we recommend that the third requirement be deleted. If the Committee concludes deletion is impossible, we recommend that the age requirement be increased above 21. Finally, if the third requirement is included, we recommend that transfers made to any trust before the effective date of the Technical Corrections Act qualify for the grandchild exemption if the trust meets only the first two requirements.

The Third Requirement Is an Unnecessary Addition. The first two [illegible]ments were generally expected by practitioners and simply repeat the re[illegible] that were necessary to obtain the $250,000 exclusion for transfers to [illegible] under the previous generation-skipping tax law. The third requirement, which requires income to be distributed at least as frequently as annually to the grandchild after the grandchild reaches age 21, is a new concept and was unexpected.

Unlike the first two requirements, the mandatory distribution of income is not necessary to protect the tax base of the Government. The first two requirements protect the Government from loss of revenue by insuring that the property in such a trust will be included in the grandchild's estate. Obviously, if property could be distributed to someone other than the grandchild from the grandchild's trust, any property so distributed would escape taxation in the grandchild's estate. The second requirement insures that even if the grandchild should die before the trust terminates, the property remaining in the trust will

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nonetheless be taxed in the grandchild's estate. Thus, the third requirement is not necessary in any way to protect estate and gift tax revenues. The first two requirements are sufficient to protect the federal fisc.

Neither are income tax revenues protected by the third requirement. Given the compression of income tax rates, no significant revenue would be lost from any accumulation of income in the trust. Further, since any accumulations of income after age 21 would be subject to the throwback rules in any event, no revenue of the federal government is protected by the third requirement.

When our office spoke with Mel Thomas of the Joint Committee on Taxation regarding the reasons for this third requirement, he indicated that the requirement was a matter of policy, designed to insure that the grandchild would have a "meaningful interest" in the trust. He indicated that the Joint Committee looked at Section 2056 of the Internal Revenue Code and Section 2503(c) in order to create the requirements for this "meaningful interest". It is our understanding that the Joint Committee combined the requirements of those two sections to generally require mandatory income distributions, but only after a grandchild reaches age 21.

It was stated by Mr. Thomas that Section 2056 contains the requirement that income must be distributed from a marital trust at least annually in order for transfers to the trust to qualify for the marital deduction. It is important to acknowledge, however, that several types of marital trusts qualify for the deduction. While a qualified terminable interest property trust or a general power of appointment marital trust must include a mandatory income payout provision, an "estate trust," which does not require current distributions of income, will also qualify for the marital deduction under Section 2056. Therefore, Section 2056 does not stand for the proposition that in order for an interest in trust to be meaningful, the trust must include a mandatory income payment provision.

The requirement that the property be included in the grandchild's estate if the grandchild dies prior to the termination of the trust, however, does give the grandchild a "meaningful interest" in the trust. Generally, inclusion in the estate is achieved either through a provision requiring the trust to be ultimately distributed to the grandchild's estate or a provision granting the grandchild a general power of appointment giving the grandchild the right to appoint the property at the grandchild's death to the grandchild's estate, the creditors of the grandchild's estate or the grandchild's creditors. Certainly, these provisions give the grandchild a meaningful interest. The grandchild can borrow against the property by obligating himself or herself to appoint the trust property to creditors or to the grandchild's estate at the grandchild's death, and the grandchild may direct the ultimate disposition of the trust.

Policy Considerations Behind the Age Requirement. While we believe mandatory payment of all income from a grandchild exemption trust should not be required, if it is required, we believe as a matter of policy that it is not advisable for a grandchild to begin receiving all of the income of the trust at age 21. Obviously, the income from a trust that has $2,000,000 (and possibly considerably more as a result of appreciation) will be quite substantial.

While age 21 is frequently used as a watershed age due to its long-standing association in many states with the age of majority, if the reasons behind the mandatory income payout after age 21 are to insure that the grandchild receives a "meaningful interest," it should be carefully considered as to whether age 21 is an appropriate age at which the income should be required to be paid out, or whether in fact the grandchild's interest might be more meaningful were that mandatory income payout, if one exists, to be started at a later age.

It is our understanding that age 21 was selected by the Joint Committee because that is the age at which a trust for a minor must terminate in order to qualify for the annual exclusion from gift taxes pursuant to Section 2503(c). A 2503(c) trust is generally created by donors to provide for a child's education and is therefore substantially smaller than a completely funded ($2,000,000) grandchild exemption trust would be. Accordingly, the requirement that trust property be distributed when a beneficiary reaches age 21 from a 2503(c) trust (by which time the beneficiary is usually near the completion of college and the assets of the trust have been substantially depleted) is not as critical as it would be in a fully funded grandchild exemption trust.

Nonetheless, it should be noted that many donors have chosen not to utilize 2503(c) trusts in recent years as a result of the mandatory payout at age 21. Our experience with clients has been that they are unwilling for a trust for a child to terminate so early, not because they desire to keep the beneficial enjoyment of the property away from the child, but because they believe the child will be better able to enjoy the property for a longer period of time if the termination of the trust occurs when the child is more mature.

The Third Requirement Is a Substantive Change Which Is Not Appropriate in a Technical Corrections Act and For Which Relief Should Be Granted From Its Retroactive Effect. Even if it is ultimately decided that for policy reasons the mandatory income payout after age 21 (or whatever age is finally determined) should be made a requirement for qualification for the grandchild exemption, the Technical Corrections Act is not the appropriate vehicle by which this change should be made. This is a substantive change which should not masquerade as a technical correction.

If this requirement is included in the Technical Corrections Act, this provision, as currently proposed, has a retroactive effect for which relief should be granted. No transfers to trusts not containing this mandatory income payout should be disqualified from using the grandchild exemption if the transfer was irrevocable before the Technical Corrections Act date of enactment.

While the Tax Reform Act of 1986 did not include provisions relating to what types of trusts would qualify for the grandchild exemption, the Conference Agreement relating to the Tax Reform Act implicitly authorized transfers to a trust. A special election is permitted to allow qualification of a pre October 22, 1986 transfer to a trust in cases where the trust estate would pass to the grandchild's heirs (and not the grandchild's estate) at the grandchild's death.

The clear implication of this special election is that for post October 22, 1986 transfers, so long as the grandchild's interest in a trust is vested (i.e., payable to the grandchild's estate or pursuant to a general power of appointment at the grandchild's death), it would qualify as a direct skip for the grandchild exemption. Non-vested interests would be permissible only if they were created prior to October 22, 1986 and an election were made to treat them in this manner (which would result in an estate tax in the grandchild's estate at the grandchild's death).

The ability to use trusts so long as the trust property would be includable in the grandchild's estate is in accord with the prior generation-skipping tax provisions. That is, to qualify for the $250,000 exclusion from taxable distributions or taxable terminations for transfers to grandchildren under the prior generation-skipping tax law, the statute stated that the exclusion existed for transfers "to a grandchild". That is the same language that was used in the Tax Reform Act of 1986 relating to the $2,000,000 exemption. The regulations under the previous Section 2613 clarified that with respect to gifts made to trusts, the exclusion for transfers "to a grandchild" would be available only if the property would be includable in all events in the grandchild's Federal gross estate if the grandchild died at any time after the generation-skipping transfer. See Reg. §26.2613-4(a).

Individuals, by wills, which are now effective as a result of the death of the individual between the date of the Tax Reform Act of 1986 and the Technical Corrections Act, have created trusts which created a vested interest in the grandchild and were therefore believed to qualify for the $2,000,000 exemption. Other individuals, for a variety of personal, health, and financial reasons, have made transfers which were irrevocable prior to the date of the introduction of the Technical Corrections Act into Congress. It would be blatantly unfair to those individuals to penalize them for creating trusts for grandchildren which would have qualified for the grandchild's exclusion under the old generation-skipping tax law (which had the identical requirement that transfers be "to a grandchild") when there was nothing in the new generation-skipping tax law or comments to indicate that such transfers would not qualify for the $2,000,000 exemption. In fact, the clear implication was that these types of trusts would qualify.

The tax cost to an individual who transferred $2,000,000 to a trust for a grandchild, of which the trust property would in fact be included in the grandchild's estate if he or she dies prior to the trust's termination, is confiscatory if the transfer is not exempt from generation-skipping taxes. That is, not only would the gift tax (or estate tax) be due, but a generation-skipping tax of $1.1 Million Dollars would be due, despite the fact that the terms of the trust met all requirements which could reasonably be expected to be the requirements on transfers to a trust for a grandchild. In addition, a gift tax (or estate tax) would be due on the generation-skipping tax paid, resulting in another $500,000, more or less, in gift taxes (or estate taxes).

Conclusion. We believe the mandatory income payout requirement after age 21 is an unnecessary requirement and should not be added by the Technical Corrections Act. If such a requirement is added, we believe the age at which such payments should begin should be changed to a later age for policy reasons. If the mandatory income payout requirement is added for transfers to a grandchild, equity demands that a provision be added that with respect to transfers made before the date of enactment of the Technical Corrections Act, a trust which meets the first two requirements enunciated in the Technical Corrections Act would be treated as meeting all of the requirements for a trust to qualify for the grandchild exemption.

We appreciate your consideration of this matter.

Yours truly,

Diane W. Bricker H. Kate Hopkins

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July 15, 1987

Robert J. Leonard, Esquire
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Re: Technical Corrections Bill

Dear Rob:

Enclosed are six copies of comments on section 114(g)(2)(D) of H.R. 2636, a provision that would amend a transition rule for the generation-skipping transfer tax.

Under the Tax Reform Act as it was passed by the House and as enacted, certain types of transfers are exempt from the generation-skipping tax if the transferor was under a mental disability to change the disposition of his property on the date of enactment and at all times thereafter. The Technical Corrections Bill would substitute "September 25, 1985," for the "date of enactment."

As is illustrated in the enclosed memorandum, this correction conflicts with general principles regarding retroactive legislation, conflicts with the Congressional intent underlying other generation-skipping tax transition rules, and is a substantive rather than technical change. It is incongruous on one hand to allow individuals until January 1, 1987, to change their wills to reflect the new generation-skipping tax, but on the other hand to subject a transfer to the tax because the transferor became legally incapable of changing his will before the new, generation-skipping tax was enacted. Retroactive legislation should not compound the family suffering associated with Alzheimer's disease and other mental disabilities.

I urge the Committee to drop section 114(g)(2)(D) from the bill.

In order to maintain family privacy, I have not identified our client in the enclosed submission. I recognize that the comments do not comply with requirements for inclusion in the printed record, and we do not expect that they will be included.

To the extent it would be helpful, I would hope to have the opportunity to discuss this matter with your staff.

Sincerely,

Ernest S. Christian, Jr.

July 14, 1987

Comments for Committee on Ways and Means Regarding Section 114(g)(2)(D) of H.R. 2636, the Technical Corrections Bill -- Generation-Skipping Transfer Tax Transition Rule for Persons with Mental Disabilities

I. Introduction

Section 1433(b)(2)(C) of the Tax Reform Act of 1986 (the "Reform Act") provides that the new generation-skipping transfer tax (the "GST tax") does not apply to certain transfers if the transferor on the date of enactment and at all times thereafter is under a mental disability to change the disposition of his property. Section 114(g)(2)(D) of H.R. 2636, the Technical Corrections Act of 1987 as introduced by Messrs. Rostenkowski and Duncan (the "TCA"), would change the reference point in Reform Act § 1433(b)(2)(C) from "date of enactment" (i.e., October 22, 1986) to "September 25, 1985." If this "technical correction" is adopted, the GST tax would apply to certain transfers by will even if the testator, because of a mental disability, became legally incapable of revising the will one year before the new GST tax was enacted. This correction is inconsistent with Congressional intent and with principles relating to retroactive changes in law and, therefore, should not be adopted.

II. Background

A. New GST Tax

The Reform Act repealed the old GST tax retroactive to its enactment and replaced it with a new one. The new GST tax is more expansive than the old tax in certain respects. For example, the new tax applies to direct transfers, by gift or will, from a grandparent to a grandchild, while the old tax did not.

Reform Act § 1433(a) provides that the new tax is generally effective for generation-skipping transfers made after the date of enactment. However, Reform Act § 1433(b)(1) states, in effect, that inter vivos transfers will be subject to the new tax if made after September 25, 1985, the date on which the Ways and Means Committee marked up and approved the new GST tax. Reform Act § 1433(b)(2) also excludes from the GST tax generation-skipping transfers under trusts that were irrevocable on September 25, 1985, and generation-skipping transfers under a will executed before the the enactment of the Reform Act if the testator died before January 1, 1987. (The TCA would expand the latter exception to apply to revocable trusts in addition to wills.)

B. Mental Disability Exception

A third exception applies to generation-skipping transfers if the transferor was, on the date of enactment, under a mental disability to change the disposition of property and did not regain competence to dispose of such property before the date of death. This rule, which is included in Reform Act § 1433(b)(2)(C), applies to:

> any generation-skipping transfer --
>
> (i) under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after the date of the enactment of [the Reform Act]), or reinvestments thereof, or
>
> (ii) which is a direct skip which occurs by reason of the death of any decedent.

The TCA would revise this exception so that it applies only if the decedent was under a mental disability on September 25, 1985. The Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) prepared by the staff of the Joint Committee on Taxation (JCS-15-87), June 15, 1987, provides no explanation for the change. It merely states:

> Finally, the bill clarifies that the decedent must have been incompetent on Septe[m]ber 25, 1985, and at all times thereafter until death, in order for direct skips or transfers of assets includible in the decedent's gross estate to be exempt from generation skipping taxes.

The mental disability exception, like the new GST tax, originated in the Ways and Means Committee. The exception in section 1223(b)(2)(B) of H.R. 3838 as reported by the Committee (and as passed by the House) is identical in every respect to the exception subsequently included in the Reform Act. However, the Ways and Means Committee report incorrectly described September 26, 1985, as the date by which the decedent was required to be mentally incompetent. See H. Rep. 426, 99th Cong., 1st Sess. 828 (1985).

The Senate bill did not include the new GST, but the Conference Committee included the new GST in the final bill. The Conference Report's description of the House bill also incorrectly stated the date by which the the House bill required the decedent to be incompetent for the mental disability exception to apply. See H. Rep. 841, 99th Cong., 2d. Sess. II-775 (1986) (the Conference Report on the Tax Reform Act of 1986, hereinafter referred to as the "Conference Report").

III. Discussion

A. The Proposed Correction Is Inconsistent with General Legislative Policy Relating to Retroactive Effective Dates.

Recently, Congress has passed many retroactive changes of law. The general principle underlying most retroactive changes is that an action by the Senate, the House, a Senate or House committee or Treasury, accompanied by notice setting a tentative effective date, puts taxpayers on notice of an impending change of law and that if a taxpayer affirmatively engages in the activity to be taxed, he may be subject to the new tax rules. In fact, in some cases the date of such action must be the effective date in order to prevent taxpayers from rushing to use loopholes before they expire. For example, after the Ways and Means Committee marked up the new GST, taxpayers who formed nontestamentary trusts under which there were generation-skipping transfers or who made gifts to grandchildren were on notice that a tax would apply to generation-skipping transfers. A retroactive effective date was needed to prevent taxpayers who wanted to make generation-skipping transfers but wanted to avoid the GST tax from rushing to make gifts to grandchildren or to set up trusts before the date of enactment. Therefore, the Reform Act grandfathers generation-skipping transfers under irrevocable trusts only if they were irrevocable as of the Committee markup on September 25, 1985, and it uses that day as the effective date for the GST tax on inter vivos transfers.

On the other hand, Congress should not expect that a taxpayer would alter or amend prior behavior based on the possibility that legislation will be enacted in the future. For example, prior to the enactment of a new tax on testamentary transfers to grandchildren, an individual has no incentive to alter his will to replace his first choice bequest to a grandchild with a second or third choice bequest (such as a bequest to charity) that would only be preferable if the proposed, new law became effective. For this reason, the Reform Act includes an exception for generation-skipping transfers under wills that were executed before the date of the enactment if the decedent died before January 1, 1987. This transition rule gave taxpayers a short period after enactment to revise their wills in response to the newly enacted legislation. (The TCA would provide a similar rule for revision of revocable trusts.)

If these general principles are applied to the mental disability rule, the GST tax ought not to apply in cases where the settlor of a trust or a testator was on December 31, 1986, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. This would have given an individual a short window period after the date of enactment to revise the applicable instrument and provide transition relief if by reason of disability the individual was unable to do so. While not ideal, the current statutory language of the Reform Act is acceptable because it at least gave the individuals a short period, from the time Congress approved the legislation to the time the President signed it, to make changes in the applicable instruments and provides relief if such person was unable to make changes because he was mentally incompetent and remained mentally incompetent until death.

However, if the proposed technical correction is adopted, the individual would have had to have been mentally incompetent on September 25, 1985. This produces an extremely unfair result. As noted above, the new GST tax applies to certain transfers to which the old GST tax did not apply. These include very basic transfers, such as transfers directly to grandchildren by will or through trusts in which no individual from an intermediate generation had any interest. Individuals who had settled such trusts or executed such wills could not have been expected to revise them immediately following the Ways and Means Committee action in September 1985. H.R. 3838 as reported by the Ways and Means Committee on December 7, 1985, did not provide warning of an immediate need to revise wills. The bill included a date-of-enactment effective date for testamentary transfers and an exemption for mental disability that occurred prior to enactment. Even a casual observer of the legislative process in December 1985 knew that it would be no easy task to get tax reform legislation through the Senate and that legislation would not be enacted until at earliest May or June; there was substantial doubt as to whether the bill would ever be enacted. After the Senate approved a bill without a new GST tax, there was doubt as to whether the final bill, if enacted, would include a new GST tax.

If an individual failed to revise a will or trust after September 25, 1985, and then the individual became disabled, the penalty is severe. Upon his death, the transfer would be subject first to the estate tax and then to the GST tax. If instead the individual had rewritten his will or trust to name his children as beneficiaries, the second layer of tax would have been postponed until his children died. Perhaps, if the individual had been aware of double taxation, he would have given a larger portion of his estate to charity.

The mental disability exception did not require a retroactive date to prevent avoidance of the new tax. No taxpayer would intentionally become mentally incompetent in order to avoid a potential, new GST tax that may not even be enacted.

B. The Proposed Correction Is Inconsistent with Congressional Intent Relating to the Effective Dates for the New GST Tax.

There are two possible views regarding Congressional intent relating to the varying effective dates for the new GST tax, but the proposed technical correction is not consistent with either view.

1. Testamentary Versus Inter Vivos Transfers

The effective date rules reflect an effort by the draftsmen to distinguish between inter vivos transfers and testamentary transfers. The distinction and the rules are somewhat confusing because in many cases it is not the inter vivos transfer of property to a trust but some subsequent event such as the death of the settlor or a contingent beneficiary that constitutes the generation-skipping transfer. Nevertheless, the distinction has some public policy base. If a retroactive date were not used for inter vivos transfers, the Committee bill would have created a window period during which individuals would have been able to avoid the new GST by making large gifts to their grandchildren and great-grandchildren. If the earlier effective date was used primarily for inter vivos transfers, there would be no reason for moving back the required date of mental disability to September 25, 1985, because the exception applies almost exclusively to testamentary transfers (i.e., direct skips that occur by reason of death and transfers under trusts to the extent that the trust consists of property included in the gross estate of decedent).

The mental disability exception, as enacted, is generally consistent with the Reform Act's approach to testamentary transfers. The Reform Act contemplates three categories of individuals making testamentary dispositions, namely individuals who were mentally competent as of October 22, 1986 and survived until January 1, 1987, individuals who were mentally competent as of October 22, 1986, but died before January 1, 1987, and individuals who were mentally incompetent as of October 22, 1986 and failed to regain competency prior to their death. For those individuals in the first category, the Act by applying to all transfers after the date of enactment allows them to change their testamentary disposition and plan appropriately for the new GST tax rules. For those individuals in the second category, the Act recognizes that terminal illness may have prevented a timely revision of a testamentary plan and excepts them from the new rules on generation-skipping transfer tax. For individuals in the third category, the Act contemplates that they may have become mentally incompetent by October 22, 1986 and therefore were unable to revise their testamentary plans. Therefore, Reform Act § 1433(b)(2)(C) exempts the testamentary plans of such incompetent individuals from the GST tax. The TCA would penalize mentally incompetent individuals by subjecting wills of such individuals executed after September 25, 1985, to the new rules despite the fact that the individual became mentally incompetent before October 22, 1986. Such individuals would be denied a fair chance to re-execute their wills to take into account the new GST tax that covers direct skips. This conflicts with Congressional intent (relating to the exclusion for testamentary transfers by individuals who died prior to January 1, 1987), as expressed in the Conference Report:

> The conferees adopted these delays in effective dates to permit a reasonable period for individuals to re-execute their wills to conform to the extenstion of GST tax to direct skips.

The proposed technical correction fails to treat equally the three categories of individuals making testamentary dispositions by singling out the mentally incompetent individual arbitrarily for retroactive application of the new rules covering generation-skipping transfers.

2. Old GST Tax Versus New Tax

There is some language in the legislative history that suggests that delays in effective dates were needed only for generation-skipping transfers that were not covered by the old GST tax. See Conference Report at II-776. Under this interpretation of intent, the September 25, 1986, date should be used as a reference point in the mental disability transition rule only if the generation-skipping transfers to which it applies were transfers that were covered by the old GST tax. The mental disability transition rule applies in the case of two kinds of transfers, direct skips and transfers under a trust to the extent such trust includes property included in the gross estate of the decedent. A "direct skip" is an outright transfer for the benefit of a person at least two generations below the transferor or a transfer of property to a trust for one or more of such beneficiaries. The old GST tax generally did not cover direct skips which occurred by reason of death. See, for example, General Explanation of the Tax Reform Act of 1986 at 1259 (hereinafter, the "blue book"). The exception applies to some trusts under which there would have been taxable generation-skipping transfers under the old GST tax and some trusts under which there would not have been taxable transfers. Since many transfers to which the mental disability rule could apply were transfers not covered by the old GST, a September 25, 1985, date would not be consistent with a Congressional intent of using the enactment date as the point of reference for generation-skipping transfers first covered by the new GST tax. If Congress wanted to distinguish between transfers covered by the old GST and transfers not covered, the exception should require that the decedent be disabled "on the date of enactment of this Act (or, in case of transfers that would have been subject to tax under chapter 13 of the Internal Revenue Code of 1954 as in effect on the day before the date of enactment of this Act, on September 25, 1985)" and at all time thereafter prior to his death.

C. The Proposed Correction Is Not Merely Technical

The proposed correction is not merely a technical correction that inserts accidentally deleted language, corrects a cross-reference, or corrects another technical error. It would change legislative language that was clear on its face and that has stood since the Ways and Means Committee bill was printed in December 1985. The proposed change was not even listed in the original technical corrections proposal, H. Con. Res. 395, 99th Cong., 2d Sess. (1986). The "blue book" (at page 1268), which in many cases noted required technical corrections in footnotes, correctly described the exclusion as enacted and did not suggest a need for a clarification.

The real technical error with respect to the mental disability exception was made by the draftsman of the Ways and Means Committee report, which incorrectly described the exception that was included in the bill. That technical error should not lead to a technical correction of the statutory language. From a tax policy perspective, the mental disability rule as enacted makes far more sense that the rule with the proposed correction included. A technical correction should improve the law, not make it worse. The result of the proposed correction would be very substantive. It will impose a double tax that would not otherwise be imposed on parts of the estates of some individuals who became mentally disabled between September 26, 1985, and October 22, 1986.

Elimination of this technical correction will not allow taxpayers to escape tax on transfers. The draftsmen were very careful on this point; the rule applies only to transfers that are included in the taxable estate of a decedent.

IV. Conclusion

The proposed technical correction is a mistake on general equity grounds, from a tax policy perspective, and from the perspective of Congressional intent as it relates to the GST tax effective date. The proposed change is not a technical change, but is substantive change that is not required on tax policy grounds. Section 114(g)(2)(D) should be deleted from the TCA.

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July 16, 1987

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RE: Technical Corrections Bill of 1987 (H.R. 2636)

Dear Mr. Leonard:

Many of my associates and I were glad to see the provisions in the Technical Corrections Bill clarifying the application of the $2 million exemption to state that a transfer to a trust is treated as a transfer to a grandchild on the three following conditions:

(1) No amount may be distributed to any person other than that grandchild during the life of that grandchild.

(2) The assets will be includible in the gross estate of the grandchild if the grandchild dies before the termination of the trust.

(3) All of the income of the trust after the child has reached age 21 must be distributed to the grandchild not less often than annually.

My question is whether the same rationale and rules will be followed in the application of the generation-skipping provisions of TRA '86 in general and not just for the $2 million exemption. The situation in which we are particularly interested involves transfers from a grandfathered trust after September, 1985 to another pre-existing grandfathered trust exclusively for a minor (perhaps limited to meeting the three above conditions) or to a pre-existing custodian account for the grandchild. We believe the law is clear that such transfers are exempt, but every practitioner with whom I have discussed the matter would hope and like to see the regulations say that the distribution from that second grandfathered trust or custodian account to the grandchild is also exempt. We believe this is true under the law, particularly in the case of custodians where the assets are indeed vested in the minor, but we would certainly hope that the situation would be specifically covered in the regulations.

If there is any question that this is not correct under the law, we recommend strongly that the above provisions in the Technical Corrections Bill be broadened to apply beyond the $2 million exemption sections to both the above situations. The same question is presented in the case of direct gifts to trusts for minors or to custodian accounts that qualify for the $1 million exemption, so that the distribution of those gifts by the receiving trust or custodian account is also exempt.

We thank you for your consideration of this matter.

Sincerely,

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July 17, 1987

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RE: Comments on Section 114(g)(2)(D) of H.R. 2636, the Technical Corrections Act of 1987 Modifying Section 1433(b)(2)(C) of the Tax Reform Act of 1986.

Dear Rob:

Enclosed pursuant to Chairman Rostenkowski's press release of June 10, 1987, as modified by the press release of July 6, 1987, the undersigned are submitting comments on H.R. 2636, the Technical Corrections Act of 1987 with respect to section 114(g)(2)(D) of that legislation. Section 114(g)(2)(D) of H.R. 2636 would substantively amend section 1433(b)(2)(C) of the Tax Reform Act of 1986 by advancing by over a year the effective date of the generation skipping transfer tax as it relates to incompetent persons. The enclosed memorandum describes the obvious non-technical and unfair nature of such a change and urges the deletion of section 114(g)(2)(D) from the technical corrections legislation.

Your attention to this matter is greatly appreciated.

Sincerely,

Richard Katcher (KK)
Richard Katcher

Kenneth J. Kies

Calvin B. Kirchick (KJK)
Calvin B. Kirchick

MEMORANDUM

SECTION 114(g)(2)(D) OF THE TECHNICAL CORRECTIONS ACT OF 1987 SHOULD BE DELETED FROM THE LEGISLATION BECAUSE IT WOULD IMPLEMENT A CHANGE IN THE TAX REFORM ACT OF 1986 WHICH IS BOTH NON-TECHNICAL AND UNFAIR

I. Introduction.

Section 114(g)(2)(D) of H.R. 2636, the Technical Corrections Act of 1987 should be deleted because it would implement a change in the Tax Reform Act of 1986 (the "1986 Act") which is not technical, which constitutes unsound tax policy, and would penalize individuals who are incapable of responding to this proposed change. Under this change, the new version of the generation-skipping transfer tax (the "GST") enacted under the Tax Reform Act of 1986 would unfairly apply to transfers upon death by persons who became incompetent after September 25, 1985, and prior to the date of enactment on October 22, 1986 -- an advance in the effective date of more than 1 year. This change should be deleted.

II. A Variety of Independent and Separate Reasons Support the Deletion of Section 114(g)(2)(D).

A. Section 114(g)(2)(D) is Clearly Not a Technical Change in the 1986 Act.

Section 114(g)(2)(D) clearly does not constitute a technical correction to the 1986 Act. The statutory language of section 1433 of the 1986 Act contains no ambiguity or lack of clarity. It unequivocally indicates that post-death transfers by persons who were incompetent on the date of enactment are not subject to the amended form of the GST.

> SEC.1433.EFFECTIVE DATES.
>
> (a)GENERAL RULE.-Except as provided in subsection (b), the amendments made by this part shall apply to any generation-skipping transfer (within the meaning of section 2611 of the Internal Revenue Code of 1986) made after the date of the enactment of this Act.
>
> * * *
>
> (b)SPECIAL RULES.-
>
> * * *
>
> (2)EXCEPTIONS.-The amendments made by this part shall not apply to-
>
> * * *
>
> (C)any generation-skipping transfer-
>
> (i)under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than

> property transferred by the decedent during his life after the date of the enactment of this Act), or reinvestments thereof, or
>
> (ii)which is a direct skip which occurs by reason of the death of any decedent;
>
> but only if such decedent was, on the date of the enactment of this Act, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. (Emphasis added.)

The House bill equivalent of section 1433(b)(2) of the 1986 Act as it relates to incompetent persons is identical to the language contained in the enacted version. It states as follows:

> SEC.1223.EFFECTIVE DATES.
>
> (a)GENERAL RULE.-Except as provided in subsection (b), the amendments made by this part shall apply to any generation-skipping transfer (within the meaning of section 2611 of the Internal Revenue Code of 1985) made after the date of the enactment of this Act.
>
> (b)SPECIAL RULES.-
>
> * * *
>
> (2)EXCEPTIONS.-The amendments made by this part shall not apply to-
>
> * * *
>
> (B)any generation-skipping transfer-
>
> (i)under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after the date of the enactment of this Act), or reinvestments thereof, or
>
> (ii)which is a direct skip which occurs by reason of the death of any decedent;
>
> but only if such decedent was, on the date of the enactment of this Act, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. (Emphasis Added.)

The Senate version of the 1986 Act contained no provision dealing with the GST. As a consequence, the Senate bill provides no guidance on this matter.

While it is true that the Ways and Means Committee Report language and the Joint Explanatory Statement of the Committee of Conference of the 1986 Act incorrectly describe September 25, 1985, as the relevant statutory date for purposes of the GST incompetency provision, justifying section 114(g)(2)(D) based on these reports is inappropriate because both the House version of the statute and the enacted version are clear and unambiguous on their face. The House report language and the Conference Report language simply represent a mistake in description of the statutory language adopted respectively by the House bill drafters and the Conference on the 1986 Act. This is demonstrated by the General Explanation of the Tax Reform Act of 1986 Joint Committee on Taxation (May 4, 1987) (hereinafter referred to as the "Blue Book") which correctly describes the enacted version of section 1433 of the 1986 Act.

> EFFECTIVE DATES
>
> The amended generation-skipping transfer tax applies to transfers after the date of enactment (October 22, 1986), subject to the following exceptions:
>
> * * *
>
> (4) Transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent if the decedent was incompetent on the date of this Act (October 22, 1986) and at all times thereafter until death. Blue Book at 1267.

In contrast to numerous other instances throughout the Blue Book, including in the discussion of the GST, there is no indication in the description of the effective date in the Blue Book that the enacted statute is in any way inconsistent with the intended rule nor that a technical correction is contemplated. This confirms the conclusion that the reference in the House Report and Conference Report to the September 25 date was in error, and was not an intended policy overriding the clear language of the House bill and the enacted statute.

B. Section 114(g)(2)(D) Substantively Represents Unsound Tax Policy Given the Context in Which the Repeal of the 1976 Version of GST has been Considered.

Independent of the apparent non-technical status of section 114(g)(2)(D), its substantive content lacks a basis in sound tax policy, particularly given the history surrounding the repeal of the 1976 version of the GST and its replacement with the version enacted as part of the 1986 Act. Virtually from the moment that the 1976 version of the GST was enacted it was soundly criticized by virtually all informed tax professionals and professional trust administrators as unworkable, incomprehensible and unfair. It became quite clear in the early 1980's that the 1976 version of the GST would be repealed outright or that it would be replaced by a substantially different tax.

The U.S. Treasury Department during the early 1980's offered a number of proposals for addressing the problems with the 1976 version of the GST. In each case, these proposals recognized that sound tax policy dictated the inclusion of ample transition relief in recognition of the level of confusion which had been created through the enactment of the 1976 version.

For example, in testimony delivered on June 27, 1983, to the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee by then acting Tax Legislative Counsel of the Department of Treasury Robert G. Woodward, the Treasury proposed the following effective date provision:

> In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date which is one year from the date of enactment. The effective date would be extended for testators who are incompetent on the date of enactment. This one-year transition rule will give estate planners time to understand the new rules and to adjust their planning accordingly. "Statement of Robert G. Woodward Acting Tax Legislative Counsel, Department of the Treasury, Before the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee" (June 27, 1983) at 15. (Emphasis added.)

The Treasury proposed this version of the effective date because "legislative uncertainty has made estate planning in this area difficult," Woodward Testimony at 10, a statement which most practitioners would view as containing a significant degree of understatement.

The Treasury's study on tax reform which was submitted to the President in December 1984 and which served as the basis for the provision enacted in the 1986 Act also recognized the need for ample effective date provisions. This legislative uncertainty had been generated by numerous generation skipping transfer proposals including Senate action on several occasions to repeal entirely the 1976 GST. Recognizing this uncertainty and consistent with its earlier proposals, the Treasury proposed the following effective date provision:

> In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts or decedents dying before the date which is one year from the date of enactment. The effective date would be extended for testators who are incompetent on the date of enactment. This one-year transition rule would give estate planners time to understand the new rules and to adjust their planning accordingly. Tax Reform for Fairness, Simplicity, and Economic Growth Volume 2, Office of the Secretary, Department of the Treasury (November 1984) at 391. (Emphasis added.)

The policy of the Treasury consistently advanced with respect to the effective date provisions of the GST, generally and specifically with respect to individuals incompetent on date of enactment, reflects sound tax policy judgments which are consistent with the complete uncertainty which surrounded this issue for over 10 years and the massive complexity of this area of law. The policy of the effective date provisions advanced by the Treasury and enacted in the 1986 Act should not be altered through the technical corrections process.

An earlier effective date provision not only ignores the confusion and uncertainty that handicaps proper planning, it also fails to provide any positive policy benefit to justify its negative impact. When new tax laws are applied to steps taken prior to the date of enactment, it is usually justified as a means of preventing "windows of opportunity" for tax avoidance by pre-enactment planning. That purpose is not served by the change now being proposed to the effective date. In the first instance, the change is being suggested (without prior announcement) a full nine months after enactment. More importantly, taxpayers simply do not plan to become incompetent to avoid an oncoming tax.

In fact, if any change should be contemplated with respect to incompetent individuals, it should be to conform their treatment to that afforded individuals who have died, because incompetency represents the equivalent of death so far as the ability to modify an individual's estate plan is concerned. The 1986 Act provides that individuals that die before January 1, 1987, are exempt from the GST. The technical corrections legislation would not modify this change. Since incompetency effectively prevents a taxpayer from modifying his or her estate plan in any manner, it would seem appropriate to provide treatment for individuals becoming incompetent prior to January 1, 1987, as comparable to a death which occurs prior to that date.

C. Individuals who Became Incompetent After September 25, 1985, and Before the Date of Enactment Would be Unfairly Penalized by Section 114(g)(2)(D).

Individuals who became incompetent after September 25, 1985, and before the date of enactment of the 1986 Act (October 22, 1986) would be unfairly penalized if section 114(g)(2)(D) were enacted. These individuals, by definition, are now incapable of modifying their estate plans in light of the newly enacted version of the GST.* Some of these individuals may have already died. Between September 25, 1985, and October 22, 1986, persons had a right to rely on the effective date provisions in the proposed bill which clearly provided that there would be no retroactive effective date except as to inter-vivos irrevocable transfers. Logically, persons did not have to change their wills and trust documents until the date of enactment or after, thus allowing their tax advisers to wait to look at the final version of the act. Even a person who feared incompetence had no reason to act otherwise because the provisions of the bill with respect to incompetence also were not retroactive. However, under the technical corrections bill, people who in fact became incompetent and unable to change their estate plans, would lose the protection of the transitional rules after the fact. This is clearly unfair. Another way of viewing the problem is that a taxpayer who died during the transition period (September 25, 1985, through December 31, 1986) is protected; a person who survived and remained competent is able to react and change his or her plan; but a person who became incompetent is denied either chance. These types of concerns obviously caused Treasury drafters of the various post-1976 Act revisions to the GST to provide ample transition relief for incompetent individuals. The merit of this policy position should not be reversed through technical correction legislation which fundamentally alters the statutory effective date provision included in the 1986 Act.

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* The implied instruction of section 114(g)(2)(D) is that a person fearing incompetence should have changed his or her estate plan merely on the basis of provisions of a Bill introduced only in the House of Representatives and not yet even approved by the Ways and Means Committee and whose clearly stated effective date was delayed. This is unreasonable. Even if this instruction could be discerned, how could it be carried out intelligently? The character of the new statute was not firmly established let alone understood by professionals. It is important to keep in mind that the Senate Bill contained no GST provisions at all, and it was entirely unclear whether any GST proposal would be included in the final bill until after the Confernce Committee made its report in October of 1986. In fact, given the pending technical corrections legislation, it is fair to say that the nature of the GST provisions cannot be understood with any certainty even today.

III. Conclusion.

Section 114(g)(2)(D) clearly represents a substantive change to the statutory provision contained in the 1986 Act. By moving the effective date of the 1986 GST for incompetent persons, fundamental inequities would be imposed on individuals who are obviously incapable of responding to such a legislative change. The obvious and apparent unfairness of such a measure is inconsistent with sound tax policy. As a consequence, section 114(g)(2)(D) should not be included as part of any technical correction legislation.

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August 24, 1987

COMMITTEE ON
RECEIVED
AUG 26 19
WAYS AND MEANS

The Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
1102 Longworth HOB

Dear Mr. Chairman:

Attached please find copies of correspondence from a constituent who has some concerns relating to the trust provisions of the Technical Corrections Act.

Any comments or information you can provide on this matter would be deeply appreciated.

With all good wishes.

Sincerely,

Bob Roe

Robert A. Roe
Member of Congress

Brenda Landrum Bingham

August 4, 1987

Representative Robert A. Roe
2243 Rayburn House Office Building
Washington DC 20515

Dear Representative Roe:

Enclosed is a letter from my attorney concerning a provision of the "Technical Corrections Act" to the Tax Reform Act of 1986. My father died in February of this year. Prior to his death he amended his will to qualify the trust established under the will for the $2 million special exemption for generation-skipping transfers. However, the trust pertaining to the generation-skipping provision gives the trustees discretion in distributing income until the beneficiaries reach the age of 35. Under the "Technical Corrections Act" the current language indicates that the exemption will only qualify if income is distributed to the beneficiaries at age 21. For this reason, if the "Technical Corrections Act" is adopted as currently drafted, my father's estate plan may not qualify for the special exemption notwithstanding his intent to do so and his taking every reasonable precaution that it would qualify.

For these reasons, I urge you to clarify the matter either by introducing and supporting an amendment to delete the requirement to distribute the income to beneficiaries at age 21, or by granting grandfather privileges for those estate plans which became effective prior to the adoption of the "Technical Corrections Act."

It is unfair and arbitrary to penalize an estate that made a reasonable attempt to qualify for the exemption because of some arbitrary provision in the Corrections Act.

I also enclose suggested changes in the language which creates problems in the Landrum Trust and which is contained in the new "Technical Corrections Act" to the 1986 Tax Reform Act.

Very truly yours,

Brenda Landrum Bingham

Brenda Landrum Bingham
50 Bradford Avenue
Upper Montclair, NJ 07043

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FRANKLIN F. WALLIS

June 23, 1987

Mrs. Brenda L. Bingham
50 Bradford Avenue
Up. Montclair, New Jersey 07043

Mr. Marquis C. Landrum
President
First National Bank & Trust Co.
P.O. Box 1867
Columbia, Missouri 65205

Dear Brenda and Mark:

Within the last week a bill has been submitted in both Houses of Congress entitled the "Technical Corrections Act of 1987" intended to clarify various ambiguities in the 1986 Tax Reform Act. One provision of the legislation specifies the type of trust which qualifies for the special exemption for generation-skipping transfers passing directly to grandchildren, and proposes to do so in a way which questions whether the transfers made by Mr. Landrum to his grandchildren will so qualify.

As you recall, your father's net estate is divided equally between Mark and Brenda's families, with 15% each passing to Mark and Brenda free from trust, 15% each in further trust for Mark and Brenda and their respective descendants, and the remaining 20% each passing directly in trust for the different "families" of grandchildren, the latter gifts being "direct skips" for purposes of the new generation-skipping transfer tax law.

The trusts for the grandchildren provide that each trust will remain in existence until the death of Mark and Brenda and the death or remarriage of their respective surviving spouses or upon such time as a grandchild attains the age of 35, if later. The Trustees are permitted to use income and principal for the benefit of a grandchild but are not required to distribute any certain amount until at least age 35. If a grandchild dies prior to the termination of his or her trust estate, the property is subject to the grandchild's general power to appoint the property as he or she wishes, a requirement necessary under the tax law to "vest the interest" and qualify for the exemption.

Because of the changes made in the 1986 Tax Reform Act, these transfers would generally be subject to a generation-skipping transfer tax of 55% (payable in addition to the estate tax) thus drastically reducing the net value of the gifts to grandchildren.

However, the Tax Reform Act included a special transition rule for gifts up to $2,000,000 per grandchild, and exempted such gifts from the transfer tax if made directly to grandchildren prior to 1990. In preparing the final amendment to your father's trust, we sought to (i) qualify these transfers for the exemption in order to preserve your father's original intent in making gifts to the grandchildren and (ii) provide that amounts in excess of the exemption for either Mark's or Brenda's children would be added to their parent's trust in order to postpone the imposition of any generation-skipping tax.

Unfortunately the Tax Reform Act of 1986 did not spell out the terms of a transfer which would qualify for the $2,000,000 exemption and, in fact, whether a trust (as opposed to an outright gift) could be used at all. However, it was widely believed that, as was the case with a similar provision in the predecessor statute (now repealed), a trust arrangement would qualify for the exemption as long as the trust property was subject to estate tax at the time of the grandchild's death, a requirement we inserted in your father's trust at the time.

The new provision introduced by the Technical Corrections Act states that, in addition, a transfer to trust will qualify only if "all of the income of the trust for periods after the grandchild attains the age of 21 will be distributed to such grandchild not less frequently then annually."

It is not absolutely clear how this provision is to be interpreted but it appears to require that the governing instrument insure that income after age 21 is automatically distributed to a grandchild. This new requirement was not included in the provisions of your father's Trust. In all likelihood it will not be sufficient for the Trustees to adopt a policy of in fact distributing the income at age 21 and while judicial reformation of the trusts represents another possibility, especially given the clear intent expressed in the Trust to qualify for this exemption, the effectiveness of such measures for purposes of satisfying the requirements of the tax law is not clearly established.

It is important to remember that this legislation has only been introduced and that it may be quite a while before it is enacted in any form. However, you must realize that technical corrections bills often do not receive the same scrutiny prior to passage and that this potential aspect of the legislation is among those topics which affect the fewest number of taxpayers. We will closely monitor the progress of the legislation and keep you informed of any developments.

At this juncture it is impossible to predict the impact of these developments. First of all, the Technical Corrections Act may be rewritten so as to obviate the problem. We would expect that various bar and professional groups may be lobbying against one or more provisions of the legislation. It is also unclear as to the extent to which this legislation can adversely impact your father's Trust, given his death prior to these revisions and the obvious reliance on the prior law. Ultimately a taxpayer who is adversely affected by what we believe to be a retroactive change in the law can be expected to challenge vigorously any unfavorable application to his detriment.

You must also keep in mind that because the trust provided that amounts in excess of the qualifying exemption are added to the parent's trust (originally intended only to defer the generation-skipping tax on property in excess of the $2,000,000 per grandchild), if it is ultimately determined that the trusts do not qualify for the $2,000,000 exemption due to the new income requirement, then the Trust may be interpreted to provide that all such funds are added to the parent's trust, with the consequence of no amounts passing to the grandchildren and no current transfer tax.

We cannot at this time give you a complete answer to these issues, but I did want to write you to let you know of this development. I trust that either of you will call me to review this further should you have any questions concerning the foregoing.

Very truly yours,

Franklin F. Wallis

Section 1433 of The Tax Reform Act of 1986 included an exemption from the generation-skipping transfer tax for a gift ("direct skip") to a grandchild occurring prior to January 1, 1990 not to exceed $2,000,000. It was widely believed that a transfer to a trust for a grandchild, which satisfied the requirements for a similar exemption under prior law, would qualify but no provision of the statute dealt with the issue.

The Technical Corrections Act, as drafted, includes the following provision governing transfers to a trust for a grandchild:

> "(B) Treatment of Transfers in Trust. - For purposes of subparagraph (A), a transfer in trust for the benefit of a grandchild shall be treated as a transfer to such grandchild if (and only if) -
>
> "(i) during the life of the grandchild, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such grandchild,
>
> "(ii) the assets of the trust will be includible in the gross estate of the grandchild if the grandchild dies before the trust is terminated, and
>
> "(iii) all of the income of the trust for periods after the grandchild has attained age 21 will be distributed to such grandchild not less frequently than annually."
>
> [; provided, however, that this clause (iii) shall only apply to property transferred after June 10, 1987.]

We believe that the bracketed language should be added to the legislation.

Clauses (i) and (ii) of subparagraph B are consistent with prior law and from a policy standpoint serve to insure that amounts passing in trust for a grandchild are not diverted to other beneficiaries without additional transfer tax and to the extent not distributed to a grandchild are subject to estate tax at the grandchild's death.

The requirement that income be distributed to the beneficiary at age 21 represents a departure from prior law and does not implement any substantial policy goal regarding the transfer tax system because income not distributed is still subject to income tax to the trust and is subject to estate tax at the grandchild's death.

We question the desirability of requiring distribution of income at age 21, given no significant revenue loss or tax avoidance to accumulation of trust income under these circumstances, but at a minimum this income at age 21 rule should have an effective date of June 10, 1987 to protect transfers made before introduction of the Technical Corrections Act.

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PLEASE REPLY TO TAMPA

July 16, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Section 114(g)(2)(D) of the Technical Corrections Act of 1987 -- Effective Date of the Revised Generation Skipping Transfer Tax

Dear Mr. Leonard:

This comment is directed to Section 114(g)(2)(D) of the Technical Corrections Act of 1987. Unless revised, that section produces the inequities described below. We have enclosed six copies of this letter together with six copies of a summary of our comment which explains the problems with the existing language and which proposes an amendment which would achieve the Committee's purpose.

Our firm represents an elderly woman who has been mentally disabled for a number of years. On January 21, 1986, she was adjudged incompetent by the Circuit Court for Pinellas County, Florida. Her condition is irreversible and she will not regain competency before her death.

Her will, executed on August 10, 1976, distributes her property to beneficiaries who are two or more generations below her. Such distributions to generation-skipping beneficiaries ordinarily would be subject to the generation-skipping tax provisions of the Tax Reform Act of 1986.

The effective date provisions of the Tax Reform Act of 1986 provide relief in certain circumstances. Section 1433(b)(2)(C)(i) of the Tax Reform Act of 1986 provides that persons who were under a mental disability to change the disposition of their property prior to the date of the Tax Reform Act of 1986's enactment, October 22, 1986, are exempt from the application of the generation-skipping tax provisions of the Tax Reform Act of 1986. Similarly, Section 1433(b)(2)(B) provides that persons who executed their wills prior to September 25, 1985 and who died prior to January 1, 1987 are also exempt. Our client's transfers currently are exempt by virtue of the mental disability exemption.

The relief granted to this woman (and to others similarly situated who are under a mental disability to change the disposition of their property) is threatened by Section 114(g)(2)(D) of the Technical Corrections Act of 1987. Section 114(g)(2)(D) changes the mental disability relief provision of the Tax Reform Act of 1986 by requiring that the person be incompetent prior to September 25, 1985, rather than prior to October 22, 1986. This change has the effect of penalizing persons who were adjudged incompetent in the period between September 25, 1985 and October 22, 1986 but who failed to die prior to January 1, 1987.

Equally anomalous is the fact that transfers made by an irrevocable trust which was irrevocable on September 25, 1985, would not be taxed except to the extent they represent distributions of property or income on property added to the trust after September 25, 1985.

The change as drafted will create the problem of proving that a decedent was "under a mental disability" on a particular date. This evidentiary problem compounds with the passage of time (the issue commonly arises at a time distant in the future, in our case at least forty or fifty years from the present). Even with satisfactory proof, we have been informed through informal discussions with representatives of the Internal Revenue Service's National Office that the term "under a mental disability" as used in the statute is being construed to mean having been adjudicated incompetent.

Obviously, the above results are inequitable and arbitrary. No conceivable policy objective is served by antedating the date of mental disability so long as the date of execution of the will occurs prior to September 25, 1985 (the date of the proposal of a revised generation-skipping tax). **We respectfully request that the arbitrary results brought about by Section 114(g)(2)(D) of the Technical Corrections Act of 1987 be corrected by clarifying the amendment as proposed in the attached.**

Yours sincerely,

Sherwin P. Simmons

Comment Regarding Section 114(g)(2)(D) of the Technical Corrections Act of 1987 -- Effective Date of the Revised Generation-Skipping Transfer Tax

Summary: Section 114(g)(2)(D) of the Technical Corrections Act of 1987 modifies Section 1433(b)(2)(C)(i) of the Tax Reform Act of 1986, the mental disability exemption, in a way that produces an inequitable and arbitrary result for persons who were adjudged incompetent in the period between September 25, 1985 and October 22, 1986 but who failed to die prior to January 1, 1987. This proposed amendment more rationally accomplishes the purposes of Section 114(g)(2)(D) of the Technical Corrections Act of 1987.

Text of Proposed Amendment: In accordance with the foregoing, Section 114(g)(2)(D) of the Technical Corrections Act of 1987 is proposed to be amended as follows:

Sec. 114. Amendments Related to Title XIV of the Reform Act.

* * *

(g) Amendments related to Section 1433 of the Reform Act.--

* * *

(2) Paragraph (2) of Section 1433(b) of the Reform Act is amended --

* * *

(D) by ~~striking out "on the date of the enactment of this Act" and inserting in lieu thereof "September 25, 1985".~~ inserting in subparagraph (C) "under a will or revocable trust executed before September 25, 1985" after "any generation-skipping transfer".

FOR FURTHER INFORMATION CONTACT: Sherwin P. Simmons, Karen E. Lewis, or Charles T. Plambeck; Trenam, Simmons, Kemker, Scharf, Barkin, Frye & O'Neill; 2600 First Florida Tower, Post Office Box 1102; Tampa, Florida 33601-1102; (813) 223-7474.

SUPPLEMENTARY INFORMATION: Prior to the Tax Reform Act of 1986 (hereafter "Reform Act"), Chapter 13 of the Internal Revenue Code of 1954, the generation-skipping transfer tax provisions (Sections 2601-2622) generally applied to any generation-skipping transfer made after June 11, 1976 (hereafter "1976 GST Tax").

Section 1433(c) of the Reform Act repealed the 1976 GST Tax, retroactive to June 11, 1976. All amounts collected under the 1976 GST Tax were required to be credited or refunded (with interest) as an overpayment. Reform Act, Section 1433(c)(1).

Section 1431 of the Reform Act creates a new tax on generation-skipping transfers, the provisions of which appear in Chapter 13 of the Internal Revenue Code of 1986 (Section 2601 - 2663) (hereafter "1986 GST Tax").

Section 1433(a) of the Reform Act provides that the 1986 GST Tax applies to any generation-skipping transfer made after October 22, 1986.

However, Section 1433(b)(2) of the Reform Act excepts from the 1986 GST Tax certain generation-skipping transfers. According to the Conference Report, the delays in effective dates were adopted to permit a reasonable period for individuals to re-execute their wills to conform to the 1986 GST Tax, or to eliminate a hardship on individuals prevented by mental disability from re-executing their wills.

Section 1433(b)(2)(C)(i) of the Reform Act excepts from the 1986 GST Tax any generation-skipping transfer under a trust to the extent that such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after October 22, 1986), or reinvestments thereof, but only if such decedent was, on October 22, 1986, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death.

Section 114(g)(2)(D) of the Technical Corrections Act of 1987 proposes to modify Section 1433(b)(2) by striking out "on the date of the enactment of this Act" and inserting in lieu thereof "September 25, 1985". This has the effect of requiring that the person be incompetent prior to September 25, 1985 rather than prior to October 22, 1986.

The description of the Technical Corrections Act of 1987 published by the Staff of the Joint Committee offers no explanation for the change in date. It appears, however, that the modification was intended to make Section 1433(b)(2) symmetrical with Section 1433(b)(1), which subjects inter vivos transfers after September 25, 1985 to the 1986 GST Tax.

The transitional rule of Section 1433(b)(1) is rationally drawn so that transfers made in contemplation of the 1986 GST Tax do not escape taxation. However, it strains reason to predicate the transitional rule of Section 1433(b)(2) on the possibility that adjudication of incompetency will be undertaken to escape taxation.

The amendment proposed by this comment avoids the problems created when an effective date is measured by a wholly fortuitous event (the date of adjudication of incompetency). The amendment also is consonant with the transition rules of Section 1433(b)(2)(A) and Section 1433(b)(2)(B), eliminating inconsistency of treatment. The amendment seeks to achieve the purposes of existing Section 114(g)(2)(D) of the Technical Corrections Act of 1987 without the existing arbitrariness.

Title XV
Section 1501

E. CLAY SHAW
15TH DISTRICT, FLORIDA

REPLY TO:

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WASHINGTON, DC 20515
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Congress of the United States
House of Representatives
Washington, DC 20515

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GOVERNMENTAL RELATIONS
CRIME

PUBLIC WORKS AND
TRANSPORTATION
SUBCOMMITTEES:
ECONOMIC DEVELOPMENT
SURFACE TRANSPORTATION
WATER RESOURCES

SELECT COMMITTEE ON
NARCOTICS ABUSE AND CONTROL

July 16, 1987

The Honorable Dan Rostenkowski
2111 Rayburn H.O.B.
Washington, D.C. 20515

Dear Dan:

I would like to request that the Committee on Ways and Means look into the date requirements that are placed on limted partnerships with regard to K-1 forms.

I understand that the Committee is making corrections to the revenue provisions of several tax bills in H.R. 2636, the Technical Corrections Act of 1987. Although my concern on K-1 information return forms is not directly related to revenue, it has a most definite effect on whether taxpayers must file for an extension and therefore pay an estimate on their tax bill.

For your information, I am enclosing a copy of a letter that I wrote to you in June regarding this issue. I would appreciate your attention to this matter.

Sincerely,

Clay

E. Clay Shaw, Jr.
Member of Congress

ECS:mp
Enclosure

HAW
FLORIDA

REPLY TO:

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Congress of the United States
House of Representatives
Washington, DC 20515

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SELECT COMMITTEE ON
NARCOTICS ABUSE AND CONTROL

June 15, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth H.O.B.
Washington, D.C. 20515

Dear Dan:

One of my constituents has brought to my attention an apparent flaw in the tax system that affects taxpayers who receive K-1 information return forms from limited partnerships.

Under Section 6031 of the Internal Revenue Code of 1986, K-1 forms must be mailed to taxpayers by April 15th -- too late to be used in preparing returns. If a taxpayer who needs a K-1 form to complete his return does not receive it before April 15th, he must file for an extension, paying an estimate of his final tax bill instead of the exact amount due.

Is there a good reason why limited partnerships should not be required to mail their K-1 forms by an earlier date? If not, I would like to change the statute to set an earlier date for mailing K-1 forms, possibly incorporating this change in the technical corrections bill of the Tax Reform Act. If such an amendment is feasible, I would like to ask for your support for this statutory change.

I appreciate your consideration of this matter, and look forward to your response.

Sincerely,

E. Clay Shaw, Jr.
Member of Congress

ECS:acc

Section 1504

NICHOLAS & CO., CPA
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Honorable Dan Rostenkowski, Chairman
House Ways & Means Committee
1102 Longworth House Office Bldg.
Washington, D.C. 20515

June 11, 1987

Dear Representative Rostenkowski:

I am writing you, in my capacity as both a taxpayer and a professional tax practitioner with over twenty years experience, to urge your consideration of a technical correction to the Internal Revenue Code needed as a result of legislation enacted during 1986. I'm sure you have received numerous similar requests so I will attempt to be brief.

Section 6661 provides for a penalty if there is a substantial understatement (as defined) of income tax on returns to be filed after December 31, 1982. Prior to October 21, 1986, this penalty was 10% of the understatement. On October 21, 1986 the Omnibus Budget Reconciliation Act of 1986 ("OBRA") was enacted, which increased the penalty to 25% for penalties assessed after October 21, 1986. On October 22, 1986 the Tax Reform Act of 1986 ("TRA") was enacted, which provided for a penalty of 20% for returns the due date for which is after December 31, 1986. While there is some confusion as to which provision is current law, the Internal Revenue Service is assessing penalties based on the OBRA provision.

Regardless of whether the penalty is 20% or 25%, the increased rate should clearly apply to returns due after date of enactment, not penalties assessed after date of enactment. The formal assessment of penalties is solely within the control of the Internal Revenue Service and is frequently delayed. I personally know of one instance when tax deficiencies for the years 1982 and 1983 were agreed upon and the additional tax paid in July, 1985. However the Internal Revenue Service did not formally assess the penalty and interest until May, 1987 and is attempting to collect the 25% penalty provided by OBRA. Taxpayers should not be unfairly penalized as a result of the Internal Revenue Service unreasonably delaying the formal issuance of an assessment.

Your committee's clarification of this apparent error would prevent many taxpayers from being unfairly assessed penalties for years for which a higher rate of penalty was not even being considered by Congress.

Yours truly,

Kenneth R. Nicholas

The Robinson-Humphrey Company, Inc.
Member New York Stock Exchange, Inc.

August 13, 1987

Re: HR 2636 and S 1350
Technical Corrections Act
of 1987

The Honorable Dan Rostenkowski
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

Title 1, Section 115 of the Technical Corrections Act amends Section 1504 of the 1986 Tax Reform Act. As I understand it, the purpose of Section 115 is to meet Congress' intent of the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509) to raise the penalty for substantial understatement of tax liability (code Sec 6661) from 10% to 25%. The problem occurred because TRA '86 (which provided for a 20% penalty) was enacted 10/22/86 while P.L. 99-509 was enacted one day earlier, 10/21/86.

I am concerned not about the penalty increase, but rather the effective date of the new 25% penalty. PL 99-509 made the penalty effective for penalties assessed after its enactment (10/21/86), while TRA '86 made the new penalty effective for returns filed after 12/31/86. The Internal Revenue Service issued a release (IR 86-149) to address the problem created by the conflict. It interpreted the law to make the 25% penalty effective for assessments after 10/21/86, however, the release concluded by stating that "although Congress intended the increased penalty provisions of the Omnibus Budget Reconciliation Act to apply to tax returns due after December 31, 1986, the IRS is studying the effect, if any, of the Tax Reform Act provisions on these returns."

From my readings of the legislative history of TRA '86 it seems clear to me that the intent of Congress was undoubtedly to make the new penalty effective for returns due after 12/31/86 rather than for assessments made after 10/21/86. This intent was well-founded, since we as taxpayers have no control over the timeliness with which the IRS reviews, audits, and assesses penalties for our returns, and with the apparent backlog being experienced by the IRS, taxpayers should not be unduly penalized due to something beyond our control. In addition, if the effective date is tied to assessments made after 10/21/86, then a gross inequity will exist between the treatment of

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taxpayers. For example, if the applicability of the penalty increase is dependent upon when the assessment was made by the Service, certain taxpayers might be subject to the new penalty because their IRS District office or agent was less timely in reviewing their returns than other districts or agents. Finally, with very few exceptions the effective dates for the changes made by TRA '86 are for returns due after 12/31/86, such that a different effective date for the new penalty would be inconsistent with the rest of the Act.

Accordingly, I strongly urge you to pursue ensuring that the proposed Technical Corrections Act of 1987 clearly delineates that the effective date of Title 1, Section 115 shall be for returns due after December 31, 1986 (as is stated in TRA '86), rather than for assessments made after 10/31/86 (as stated in the Omnibus Budget Reconciliation Act). That is, the penalty increase from 10% to 25% shall be applicable to returns due after 12/31/86. If you disagree I would appreciate a response.

Sincerely,

Richard J Saunders

Richard J. Saunders

RJS/mc

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July 10, 1987

Mr. Robert Leonard, Chief Counsel
Committee on Ways and Means
United States House of Representatives
1102 Longworth
House Office Building
Washington, D.C. 20515

Dear Sir:

You have requested comments in connection with the Omnibus Reconciliation Act of 1986, P.L. 99-509, (the "Act"). Our comments are solely with respect to retroactive application of the twenty-five percent (25%) substantial understatement penalty. Section 8002(c) of the Act repealed §1504 of the Tax Reform Action of 1986 ("TRA 86") and raised the penalty for a substantial understatement of income tax under Section 6661(a) of the Internal Revenue Code from ten percent (10%) of the underpayment to twenty-five percent (25%) of the underpayment. This increased penalty, which is applicable to all assessments made after October 26, 1986, the date the Act was enacted, serves as an unjust retroactive penalty on many taxpayers who are determined to have substantially understated their taxes while the 10% penalty was the law. These taxpayers, who made tax return filing decisions based on the law in effect at the time their returns were prepared, now unexpectedly find that they are being assessed a two and one-half times larger penalty. Had they known at that time that included in the risk that their position might not be sustained was the assessment of a 25% penalty, they might have made a different decision. This result is not only unfair, but may be prevented by the Constitution.

Article I, Section 9, clause 3 of the Constitution provides that no ex post facto law shall be passed. Although one view has it that this prohibition is limited to criminal penalties, the issue is far from settled. Indeed, commentators have found historical support for the proposition that the founding fathers understood the ex post facto prohibition to include both civil and criminal laws.[1]

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[1] See, Crosskey, The Ex-Post-Facto and the Contracts Clauses in the Federal Convention: A Note on the Editorial Ingenuity of James Madison, 35 U. Chi. 2. Rev. 248 (1968); Crosskey, The True Meaning of the Constitutional Prohibition of Ex-Post-Facto Laws, 14 U. Chi. L. Rev. 539 (1947); Field, Ex Post Facto in the Constitution, 20 Mich. L. Rev. 315 (1922).

While Calder v. Bull, 3 U.S. (3 Dall.) 386 (1798), applies the ex post facto prohibition to criminal penalties only, other cases have used the clause to strike down civil penalties as well. See, Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810), (seizure of person's property by legislative fiat for past innocent act would constitute an ex post facto law), United States v. WHAS, Inc., 253 F. Supp. 603 (1966), (announcement by Federal Communications Commission, for the first time, that its acts and regulations required candidate identification in addition to sponsor identification, and in the same announcement prior contrary performance is deemed to be willful, constitutes ex post facto condemnation). See also, Cummins v. Missouri, 71 U.S. 333 (1867), and Ex parte Garland, 71 U.S. 333 (1867), (laws requiring person to take oath denying certain past behavior or lose the right to engage in certain professions were held to be ex post facto laws despite their failure to define any crimes); Burgess v. Salmon, 97 U.S. 381 (1878), (a civil law was struck down as an ex post facto law due to its essentially criminal nature).

This increased tax penalty violates the same standards used to strike down ex post facto legislation. The retroactive enactment of the penalty fails to provide adequate notice to those subject to its terms and frustrates their reliance on previously existing law. See, Ex Post Facto Limitations on Legislative Power, 73 Mich. L. Rev. 1491, 1496 (1975).

Fair warning under Act §8002(c) was not supplied in two respects. First, the retroactive application of the penalty was added to the bill at the last minute. There was not adequate discussion about this aspect of the bill. Indeed, it was fairly assumed that, like the original Section 6661(a) of the Internal Revenue Code and §1504 of TRA 86, the increased penalty would apply only to returns due (without regard to extensions) after passage of the act, not to assessments made after enactment. Second, the proposed penalty would apply to conduct that occurred before the bill was even introduced. Taxpayers had no notice at the time they filed their returns that a substantial understatement would result in a penalty of twenty-five (25%) of the amount underpaid. Given the surprise inclusion of a retroactive clause, taxpayers could not possibly have altered their behavior to avoid the increased penalty.

In close connection with the concept of fair warning, this penalty also betrays taxpayers' reasonable reliance upon existing law. Taxpayers who filed their tax returns prior to the passage of the Act, but have been or will be assessed after its enactment, relied upon Section 6661(a) of the Internal Revenue Code as it then existed, and were fully justified in their belief that they could be liable for a penalty only to the extent provided under current law. Had they known of the retroactive increase in the penalty amount, they may have refrained from acting as they did. This reliance is particularly reasonable in light of Section 6661(a), which was enacted prospectively.

At least one commentator has suggested that ex post facto legislation be evaluated in a different light. Ex Post Facto Limitations, supra, p. 1501-2. This commentator proposes that legislation (whether criminal or civil) be scrutinized according to three factors: does the law penalize activities in the absence of fair notice and frustrate reasonable reliance on existing law, can the legislation serve its ostensible purpose, and can the law be the consequence of legislative vindictiveness. The interests of the government in legislative and administrative flexibility must be balanced against these factors. As previously noted, Act §8002(c) frustrates past reliance by taxpayers on previously existing law and was enacted without fair warning. In addition, from the government's point of view, this penalty could be administered in a non-retroactive manner, as was Section 6661(a), without undue burden. In fact, it seems that the only purpose underlying the retroactive application of the increased penalty is revenue enhancement. This is a curious purpose for a statute that originally was enacted to correct undesirable behavior.

The statute is also subject to random application. Taxpayers who understated, but then settled with the government before the Act was enacted, were subject to only a ten percent (10%) penalty. In contrast, those who may have filed at the same time, but were assessed at a later time will be subject to a twenty-five (25%) penalty for the same act. For this reason, the amount of the penalty levied against taxpayers has become a matter of pure chance.

Due to its violation of the standards of reliance and notice and its random application, Act §8002(c) could potentially fall under constitutional attack. If this law were to be struck down (possibly several years into the future), the government's liability would be extremely high. Even if the legislation is constitutional, it is patently unfair, and is therefore inconsistent with one of the stated purposes of the Tax Reform Act of 1986.

Very truly yours,

WYATT, TARRANT & COMBS

Thomas J. Luber

Thomas J. Luber

Section 1511

Re: Amendment to Sec. 1511 of the Tax Reform Act of 1986 Relating to Interest on Estate Taxes on Vested Remainders Postponed Under Section 6163.

I. Introduction

This statement is submitted by John B. Huffaker as counsel for the Executor of the Estate of Mary P. Benson and the Executor of the Estate of Eleanor P. Morris. The decedents were sisters, the former dying in 1964 and the latter in 1966.

Sec. 1511 of the Tax Reform Act of 1986 changed the way that interest on unpaid taxes, including estate tax, is computed. It provided for interest to vary quarterly (instead of semi-annually) to reflect the current rates on three-month Treasury bills and created a 1% addition to the interest charged taxpayers as compared with the interest on refunds. This differential reflects the underlying concept that the deferral is a series of short term loans by the Treasury to the taxpayer (or by the taxpayer to the Treasury in case of overpayments).

We urge that the 1986 Act be changed to recognize that in certain limited circumstances the "loan" should be viewed as a long term loan at a rate of interest fixed at the time the tax liability is incurred. We believe that current law imposes an unintended hardship when the major asset of an estate is a vested remainder and the payment of the tax and interest is deferred pursuant to Section 6163.

A vested remainder occurs when the decedent had the right to receive the corpus of a trust upon the termination of another person's prior right. Both of the estates upon whose behalf this statement is submitted involved this fact pattern - that is, a father established a trust for each of his two daughters subject to a life estate in their mother and both daughters pre-deceased their mother who is still living.

Thus the vested remainder is an asset to be valued in each daughter's estate and a tax computed. However, in recognition of the fact that the trust is not available as a source for payment of the tax, the executor may postpone payment of the tax under Section 6163 until mother's death. This provision has been part of our estate tax since its inception. Interest accrues on the unpaid tax -- our request is for Congress to provide a special rule for computing the interest. A special rule was provided until 1975.

When the vested remainder is a large part of the estate, the deferral is involuntary because the executor does not have assets available to pay the tax. In the above example, assuming one daughter had died in 1964 (as actually happened), by current date the tax plus the accrued interest would be in excess of the value of the trust principal when the daughter died.

II. Valuation and Taxation

A vested remainder is valued by formula at the date of death, taking into account (1) the market value of the trust principal, (2) the life expectancy of the income recipient and (3) the discount rate set by the Treasury.

1. Discount Rate

The discount rate at the date of death is critical to the tax burden. A small discount means a bigger value and a bigger tax; a big discount means a smaller value and a smaller tax. The discount rate was 3½% prior to 1975, then 6%, and, since 1983, 10%. The discount rate is established by the Treasury.

2. Deferral Interest Rate

Deferral interest accrues on the estate tax postponed. Prior to 1975 a special low rate was provided for vested remainders (4%) recognizing their unique nature. In 1975, Congress provided a floating rate on all unpaid taxes without considering the impact on vested remainders.

3. Overall Tax Burden

The overall tax burden on estates with vested remainders is the estate tax plus whatever deferral interest accrues. Sec. 6163 allows deferral until six months after the death of the income beneficiary since that may be the earliest funds are available to meet the burden.

III. Illustration of Hardship

The change made in 1975 can cause a huge increase in the interest burden. For example, consider a vested remainder in $1 million subject to a twenty-year deferral and subject to a 50% estate tax:

	Value of $1 Million Remainder for Estate Tax Purposes	50% Estate Tax	Annual Interest at 4%	Annual Interest at 10% Rate
3½% Discount Table Used Prior to 1975	$500,000	$250,000	$10,000	$25,000
Current 10% Discount Table	150,000	75,000	3,000	7,500

Because the estate tax remains constant after the initial computation, the fluctuation in deferral interest rates produces wild swings. This table shows that the combined interest and tax burden anticipated when the election was made to postpone the tax in 1966 was a tax of $250,000 and annual interest on the tax of $10,000 at 4%. The initial tax burden would only have been about $75,000 if the current 10% discount rate had been in use and the interest $7,500 at a 10% rate. In each case the discount rate and interest rate reflect the economic situation on the valuation date. However, when current law applies a rate of 10% to the tax of $250,000, we see the equivalent to a 33 1/3% rate on $75,000. This 33 1/3% rate is not a theoretical "worst case" -- it is actually happening in each of the estates.

IV. Corrective Action

1. What Congress did in the 1986 Act by changes in the way of computing interest on unpaid taxes was to aggravate a bad situation. However, the right rule to prevent undue hardships to estates with vested remainders is to use consistent rates for both valuation of the remainder and interest on the postponed tax. We request an amendment to relate the two rates.

2. The most glaring cases of hardship are when the remainder interest was the major part of the estate. Therefore, the amendment should be restricted to instances when the remainder interest is more than 50% of the adjusted gross estate. We do not propose extending the new rule to reversions because the same potential hardship does not exist.

3. The Amendment applies to all amounts of interest that were accrued but not payable as of the date of enactment of the 1986 Act. However, no recomputation of interest would be provided when the interest has been previously paid. That limitation removes any chance of a double benefit.

4. Future changes in interest rates may provide a potential windfall when the discount rate was high on the valuation date but there is a lower current interest rate. That possibility is removed by the amendment.

5. A technical consideration is that discount rates are generally only reset at long intervals, while the interest rates are reset each quarter. For this reason the Amendment covers situations in which the interest rate and discount rate are considerably apart at the outset. While this was not the situation with either of the estates for whom this is submitted, we believe it appropriate to cover the possibility.

We are certain that anticipated revenue loss would be very small. The text of the suggested Amendment is attached.

Attachment

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Section 1511 of the Tax Reform Act of 1986 is amended by adding the following at the end thereof:

SEC. ___. RATE OF INTEREST ON POSTPONED ESTATE TAX ATTRIBUTABLE TO REMAINDER INTERESTS IN PROPERTY.

(a) IN GENERAL.--Section 6601 of the Internal Revenue Code of 1986 (relating to interest on underpayment, nonpayment, or extension of time for payment, of tax) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) RATE OF INTEREST ON ESTATE TAX POSTPONED UNDER SECTION 6163 WITH RESPECT TO REMAINDER INTERESTS.--

"(1) IN GENERAL.--If--

"(A) the time for payment of an amount of tax imposed by chapter 11 is postponed as provided in section 6163 with respect to any qualified remainder interest, and

"(B) the value of the qualified remainder interests included in determining the gross estate of the decedent exceeds 50 percent of the value of the adjusted gross estate, interest on the amount so postponed to the extent attributable to qualified remainder interests shall (in lieu of the annual rate provided by subsection (a)) be paid at the modified underpayment rate, compounded annually.

"(2) MODIFIED UNDERPAYMENT RATE.--For purposes of paragraph (1)--

"(A) IN GENERAL.--Except as otherwise provided in this paragraph, the term 'modified underpayment rate' means the underpayment rate modified (if any) as provided by subparagraph (B).

"(B) COORDINATION WITH DISCOUNT RATE USED FOR VALUATION PURPOSES.--

"(i) UNDERPAYMENT RATE IN EXCESS OF DISCOUNT RATE BY MORE THAN 1 PERCENTAGE POINT.--If the underpayment rate exceeds the discount rate by more than 1 percentage point, the term 'modified underpayment rate' means the percentage equal to the sum of the discount rate and 1 percentage point.

"(ii) DISCOUNT RATE IN EXCESS OF UNDERPAYMENT RATE BY MORE THAN 1 PERCENTAGE POINT.--If the discount rate exceeds the underpayment rate by more than 1 percentage point, the term 'modified underpayment rate' means the percentage equal to the discount rate minus 1 percentage point.

"(C) UNDERPAYMENT RATE; DISCOUNT RATE.--For purposes of this paragraph--

"(i) UNDERPAYMENT RATE.--The term 'underpayment rate' means the underpayment rate established by section 6621.

"(ii) DISCOUNT RATE.--The term 'discount rate' means the rate used to value a remainder interest in property for purposes of chapter 11.

"(iii) RATES DETERMINED AS OF DUE DATE FOR ESTATE TAX RETURN.--The underpayment rate and the discount rate used for purposes of this paragraph shall be such rates as in effect on the last date prescribed for filing the return of tax imposed by chapter 11 (determined without regard to extensions thereof).

"(3) OTHER DEFINITIONS.--For purposes of this subsection--

"(A) QUALIFIED REMAINDER INTEREST.--The term 'qualified remainder interest' means any remainder interest other than a reversionary interest.

"(B) ADJUSTED GROSS ESTATE.--The term 'adjusted gross estate' has the meaning given such term by section 6166(b)(6).

"(C) VALUE.--Value shall be value determined for purposes of chapter 11 (relating to estate tax)."

(b) EFFECTIVE DATE.--

(1) IN GENERAL.--The amendments made by this section shall apply to interest on taxes the payment of which is postponed until after October 21, 1986, under section 6163 of the Internal Revenue Code of 1986.

(2) EXCEPTION FOR INTEREST PAID.--The interest required to be paid with respect to an estate tax postponed under section 6163 of such Code after the application of the amendment made by this section shall not be less than the interest paid on or before October 21, 1986, with respect to the estate tax so postponed.

Section 1521

COMMENTS

AMERICAN ESCROW ASSOCIATION

ON

PROHIBITION OF SEPARATE CHARGE FOR FILING RETURNS

(2)A SUBSECTION (E) OF SECTION 6045 OF THE 1986 CODE

The following comments are submitted by Mr. James D. Santini, Washington, D.C. representative of the American Escrow Association (hereinafter referred to as AEA) to the 1987 House Ways and Means Committee proposed "technical corrections" to the 1986 Tax Reform Act and Code.

The AEA is an association of professional escrow and settlement agents conducting real estate transaction business in the eleven western states. Our association joins with the American Land Title Association and The Mortgage Bankers Association in expressing strong objection to the proposed "prohibition of separate charge for filing return."

> "It shall be unlawful for any real estate broker to separately charge any customer for complying with any requirement of paragraph (1)." (Amendment to (2) (a) subsection (e) of Section 6045 of the 1986 Code).

The American Escrow Association urges the committee to reconsider the proposed prohibition on transaction costs.

The AEA believes that both The Internal Revenue Service and The Department of Treasury would agree that the escrow and settlement professionals are doing their best to comply with both the letter and the spirit of the 1986 Reporting Act requirement. However, the proposed prohibition on charging any fee for the costs related to the 1099B is a bit like adding insult to injury. In the first instance, the settlement professionals never wished to tackle the responsibility of undertaking Internal Revenue Service reporting obligations. However, with that established as the law of the land, they have endeavored conscientiously to comply with that law. Now back comes the government with a proposal that says that not only did we visit upon you unwanted responsibilities but now we are prohibiting you from recovering the real costs related to implementing those responsibilities.

AEA appreciates congressional concern about those isolated instances of real fee charging abuse. However, in the overwhelming majority of transactions, there is a businesslike and accurate effort to have the costs reflect the expenditures incurred in complying with the reporting requirements.

The association urges the committee to recognize and appreciate that there are very real and significant costs related to complying with the Real Estate Reporting mandates. This is not just a simple matter of filling out a form and filing it away. There are substantial start up costs with the computer implementation of the 1099B program. Some reports have had to be done several times during the interim period that preceded the regulations. Many transaction agents have spent more time explaining why the 1099B form has to be filled out than it took them to close the entire escrow. There is no question that the escrow agent is involved in a significant adjustment period to implementing this new 1099 procedure. Certainly over a 1-2 year period of time that adjustment will be completed and the implementation of the 1099B will become a standardized routine. However, in the interim there is a tremendous cost incurred by employers for the time expended in this adaptation.

The escrow and transaction agent have been asked to shoulder an entirely new administrative responsibility. AEA urges the committee to appreciate and understand that escrow and transaction agents are not Internal Revenue Service employees. They do not have a working command and familiarity with IRS procedures, routines and the specifics of adapting to the 1099B requisite. A tremendous education process is underway. The company certified public accountant has been besieged with ongoing inquiries. AEA urges the committee to appreciate that the start-up or first year charges will necessarily be larger until the practice of conforming to the 1099B becomes routine. There is no question that when the adaptation period is completed, the costs related to this processing will level out.

What are the actual costs? Ms. Gwen Van Vleck, Second Vice President and Legislative Chairman of the American Escrow Association has estimated the legitimate, actually incurred costs for association members at between $15 and $50. AEA would be happy to submit a detailed factual break-out of those actual costs. Again, by way of emphasis, to deny charging any costs for processing a 1099B seems grossly unfair under the circumstances.

In the eleven western states represented by the AEA, the escrow and transaction agent business is intensely competitive. Marketplace forces have in the past and will in the future dictate shaving costs wherever possible in order to gain a competitive edge in that marketplace. Gouging for transactions fees related to the 1099B would be self defeating. That is a principle reason that abuses have not been evidenced in any number in our region.

The proposed prohibition on any line item entry for processing the 1099B creates another professional dilemna for the escrow and settlement agent. These professionals have cut their teeth on "disclosure" and have been vigorous advocates with both the Internal Revenue Service and The Treasury Department in providing more specific information under the Real Estate Reporting requirement. IRS and Treasury will substantiate this conclusion. However the proposed prohibition on any specific entry for the transaction costs seems grossly at odds with the disclosure commitment of the AEA membership. It is at odds with the general federal standard that disclosure is in the best interest of the American consumer. Give that consumer all of the specific information and the prospect is is improved that the consumer can protect himself.

The association urges the committee to consider the practical consequence of the line item prohibition. For some of our association members it will prove practically impossible to pass on the actual costs outlined above because of the nature of their settlement office business. On the other hand, other transaction agencies will be compelled to take the real cost associated with the settlement transaction and bury those costs in other itemizations on the closing form. In the first instance, it is grossly unfair to impose a cost without allowing it to be recovered and in the second instance, you have frustrated the consumer's right to know the actual basis for costs imposed.

The AEA member is a professional engaged in providing a valuable professional service. There is no reason that our association members should be denied compensation for their service. It is not fair for the federal government to create an unwanted duty or responsibility for the settlement agent and then turn around and tell that settlement agent that he/she is not entitled to a fair and just compensation for providing the federally mandated reporting requirements.

If the committee should invite any additional specific information fact or figures AEA stands ready to supply that information.

For the foregoing reasons, AEA urges the committee to reject the proposed prohibition of a separate charge for filing the 1099B. AEA suggests that both common sense and common fairness compels this result.

Respectfully submitted,

James D. Santini
Washington Representative
American Escrow Association

COMMENTS OF
AMERICAN LAND TITLE ASSOCIATION
TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
REGARDING
TECHNICAL CORRECTIONS ACT OF 1987

July 17, 1987

The American Land Title Association (ALTA) wishes to thank the Committee on Ways and Means for the invitation to comment on H.R. 2636, the Technical Corrections Act of 1987. The ALTA takes this opportunity to respectfully request that section 115(e)(2) be deleted from H.R. 2636. This statement is submitted to the Committee on Ways and Means by the ALTA on behalf of our members.

A. Description of the Association

The ALTA, founded in 1907, is the trade association representing 2,300 abstracters and agents, title insurance companies and associated members. The ALTA members directly employ more than 100,000 people and engage thousands of independent attorneys as agents. The ALTA was organized to promote the safe and efficient transfer of ownership of real property. To this end, the ALTA endeavors to provide information and education to consumers and to those who regulate, supervise or enact legislation affecting the land title industry.

B. Description of Section 115(e)(2)

Section 115(e)(2) of H.R. 2636 would add new paragraph (3) to section 6045(e) of the Internal Revenue Code of 1986. The Tax Reform Act of 1986 amended section 6045 to require a "real estate broker" to file information returns with respect to certain transactions in real estate. In most cases, the person responsible for reporting the transaction is the settlement agent. Section 115(e)(2) would prohibit the settlement agent from separately stating to any customer the cost of reporting the transaction. The ALTA believes that this provision is not appropriate for technical corrections legislation because it represents a substantive change in the law. We further believe that legislation of this nature is premature, represents unnecessary and inequitable regulation of the real estate settlement industry and is contrary to sound tax policy.

C. Arguments Supporting the Deletion of Section 115(e)(2)

Section 115(e)(2) is not a technical correction but a substantive change in the law. The scope of the Technical Corrections Act should be limited to fine-tuning new provisions and correcting mistakes that were made in the Tax Reform Act of 1986. Section 115(e)(2) is much more than a minor adjustment. There are considerable policy implications associated with using the tax code to regulate how an industry may price and advertise its product. This alone should suggest that H.R. 2636 is not the proper legislative vehicle for this provision. Legislation of this nature should be the topic of extensive public comment and debate. It should not be included in a technical corrections bill.

Section 115(e)(2) was introduced before Congress had the opportunity to observe information reporting on real estate transactions in practice. Real estate reporting had been required for only one month at the time H.R. 2636 was introduced.[1] Settlement agents have not had the chance to determine what the additional cost will be, much less whether the cost should be absorbed by the agent or passed on to the seller. Our members anticipate that the bulk of the cost of information reporting will be incurred during the initial years. New computer equipment will have to be purchased and systems to accommodate reporting must be designed. The cost of reporting should taper off significantly after the initial investment is made. Our members believe that, at the very least, the cost data should be available before a provision is enacted regulating how the settlement agents may treat these amounts.

Even after the necessary cost data becomes available, settlement agents should not be regulated as to how they may advertise or price their services. The business of closing real estate transactions is a highly competitive one. The ALTA alone represents thousands of settlement agents, all competing with each other for business. Settlement agents are not in position to force consumers to pay additional costs. The free market will inevitably shake-out any agents attempting to gouge the consumer with excessive fees.

Like any other business confronted with the additional cost of information reporting to the IRS, settlement agents must decide whether to absorb the cost or pass it on to the customer. Section 115(e)(2) would treat settlement agents unfairly in this respect. No other information reporter is restricted with respect to how such costs are handled. Most information reporters have an ongoing relationship with their customers. Thus, they are able to recover the cost of information reporting over time in small increments. Settlement agents, on the otherhand, are unique in that they have a one-time relationship with their customers. Costs that are not recovered up front will never be recovered. By interfering with their ability to recover these costs, section 115(e)(2) places settlement agents at a disadvantage with respect to other information reporters.

A real estate closing can be a very confusing event for the typical buyer or seller. Without adequate disclosure it would be very difficult to keep track of all the closing costs. To relieve some of this confusion, the Real Estate Settlement Procedures Act (RESPA) requires settlement agents conducting settlements involving any Federal related mortgage loan to prepare a HUD-1 Settlement Statement. The HUD-1 itemizes the costs associated with the closing and discloses how the costs are allocated between the buyer and the seller. In this manner, the parties to a transaction know exactly what the costs are and who is responsible for them. This policy of disclosure promotes understanding of the closing process and enhances the credibility of the real estate industry. However, section 115(e)(2) runs completely contrary to this policy. It would, in effect, require the agent to withhold certain cost information from the customer. It is not good tax policy to enact a provision that requires a taxpayer to conceal price information from its customer.

The ALTA believes that its members should be allowed to price their services (and communicate those prices to the customer) in a manner that is free from government regulation. Furthermore, buyers and sellers of real estate have a right to know exactly what they are paying for. We, therefore, urge the Committee to delete section 115(e)(2) from the H.R. 2636.

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[1] Real estate information reporting technically is required for transactions closed after December 31, 1986. However, Temporary Treasury Regulation Section 1.6045-3T(p) provides that no penalty will be imposed with respect to a transaction closed before May 4, 1987. The TCB was introduced on June 10, 1987.

ROBERT J. LAGOMARSINO
19TH DISTRICT, CALIFORNIA

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CONFERENCE SECRETARY

CONGRESSIONAL OBSERVER
GENEVA ARMS CONTROL TALKS

CONGRESSIONAL TASK FORCE ON
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POW/MIA TASK FORCE
CHAIRMAN

Congress of the United States
House of Representatives
Washington, DC 20515

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AFFAIRS
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VICE CHAIRMAN—PARKS

August 19, 1987

Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

Please find enclosed the letter I received from my constituent, Carol Hixenbaugh of Solvang, CA regarding the Technical Corrections Act.

Your review of the issues raised by Ms. Hixenbaugh is requested and appreciated.

Sincerely,

Robert J. Lagomarsino

ROBERT J. LAGOMARSINO
Member of Congress

RJL:imm
Enclosure

August 13, 1987

The Honorable Robert Lagomarsino
2332 Rayburn Office Building
Washington, D.C. 20515

Re: 1986 Tax Reform Act
Prohibition of charging customer for services
required as a result of this Act.

Dear Congressman Lagomarsino:

I am the office manager of Santa Ynez Valley Escrow Company, Solvang, California. Everyone in our industry is attempting to comply with the requirement that we report all conveyances of real property to the Internal Revenue Service with few exceptions.

I have received word that both the House and Senate versions of the Technical Corrections Bill contains language which would prohibit a "line item charge" to the parties in an escrow for costs incurred in complying with the IRS reporting requirements.

My objections are as follows:

1. Since the IRS requires that we report on magnetic tape, we must contract with a firm which has the required equipment. Our cost is $10.00 per report which we must pay to the reporting firm.

2. We have our own costs of preparing the form, sending it to the parties, follow-up calls, and the handling of the forms to send to the reporting company.

There have been times during the last two years when both the owner of this company and I have reduced our salaries or gone without them completely because of the extreme slow-down in the economy, particularly the real estate industry. If this additional expense is imposed on us without the ability to pass the cost on, it could affect our ability to remain open when the business slows down again. I have heard that it has been suggested that we "bury" our reporting fee in our escrow fee. Since the Seller and Buyer divide the escrow fee equally, it would require the Buyer to share the expense of the reporting requirement for the Seller. Why "hide" the charges???

The government imposing a requirement on business without the ability to recoup the additional cost does not seem like the "American way". I understand that Senator Howard Metzenbaum has introduced legislation limiting reporting fees to $5.00 (SB-1186). I would not be opposed to having a limit; however, as you can see $5.00 is not a realistic limit. Perhaps a limit of $10-$20 over the amount we must pay a reporting service.

I would sincerely appreciate your assistance in protecting our interests in the escrow industry.

Sincerly,

Carol Hixenbaugh

Carol Hixenbaugh
P.O. Box 498
Solvang, Calif. 93463

Section 1541

3823 Macklem Avenue
Niagara Falls, New York 14305-1833
30 June 1987

Hon. Dan Rostenkowski
Chairman of Ways and Means Committee
Rayburn House Office Bldg. Rm 2111
Washington, D. C. 20515

Dear Mr. Rostenkowski:

It has been reported that various Congressional committees and subcommittees are considering changes and corrections to the income tax reform law passed by Congress in 1986. Many taxpayers have to file estimated tax returns on Form 1040-ES and that is the subject of this letter.

One change which should be considered is the un-realistic date of January 15th for the filing of the final estimated tax payment. This date should be changed to January 31st or February 1st of any given year. This change is practically imperative if 90% compliance by this date is going to be required. Other reasons are stated below.

When a taxpayer's income changes significantly in the last quarter of the year due to a company bonus, capital gains, or extra year-end income, the required information is not on hand by January 15th and many times the required W-2 Forms and other pertinent data are simply not received by the taxpayer until January 31st and after.

The people who submit this information have, by law, until January 31st to supply it and many use this time limit to the hilt. Others do not even make it. The sensible thing to do is to allow a period of 16 more days for most of this paper work to clear the mails and be delivered to the taxpayer. A more accurate final estimate of tax could then be made which would avoid penalties for under-estimating the final tax due.

On a separate attached sheet are listed the Present and Proposed Filing Dates for Form 1040-ES. Please take note of the following items:

1. The date for the 1st installment (April 15th) has not been changed.
2. The date for the 4th installment has been moved to January 31st.
3. The intervals between filing dates are more uniform.
4. The longest interval has been reduced 14 days, from 122 to 108 days.
5. The shortest interval has been extended 13 days, from 61 to 74 days.

The proposed dates would also provide a more even flow of money from the taxpayer to the government. It would be easier for the taxpayer to meet the required payments. The new dates are a positive way to provide more accurate information.

The suggested changes are intended to improve tax payments and compliance and have nothing to do with tax avoidance. Please give these suggestions serious consideration and try to include them in your new tax reform package.

Very truly yours,

Elton L. Burmaster
Elton L. Burmaster

Estimated Tax Form 1040-ES

Present Filing Dates

Installment Due		Days Interval Between Dates
#1 April	15	61
#2 June	15	92
#3 September	15	122
#4 January	15	90
#1 April	15	
		365

Proposed Filing Dates

Installment Due		Days Interval Between Dates
#1 April	15	91
#2 July	15	92
#3 October	15	108
#4 January	31	74
#1 April	15	
		365

Filing dates are set by law. They are NOT set by the IRS.

If all the intervals between filing dates were equal, the interval would be 91 to 92 days.

Advantages of the Proposed Filing Dates over the Present Filing Dates:

1. The date for the 1st installment has not been changed.
2. The date for the 4th installment has been moved to January 31st.
3. The intervals between filing dates are more uniform.
4. The longest interval has been reduced 14 days, from 122 to 108 days.
5. The shortest interval has been extended 13 days, from 61 to 74 days.

Other items to consider:

The proposed dates would provide a more even flow of money from the taxpayer to the government.

The new dates would be a positive way to provide more accurate information.

Section 1960

City of Cleveland
GEORGE V. VOINOVICH, MAYOR

July 6, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways And Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: H. R. 2749 Amendment to
Technical Corrections Act of
1987

Dear Mr. Leonard,

H. R. 2749 was recently introduced by Congresswoman Marcy Kaptur amending H. R. 2636, the Technical Corrections Act of 1987. This amendment would allow Cities such as Cleveland, Columbus, Cincinnati, Toledo, Dayton and Akron in Ohio with populations in excess of 250,000 to obtain information directly from I.R.S. for the purpose of insuring compliance with the local income tax ordinances.

This bill adjusts the population threshold from 2,000,000 to 250,000 which was established by prior legislation and it is not a new law.

As the Commissioner of Taxation for the City of Cleveland and Administrator of the Central Collection Agency I strongly urge inclusion of H. R. 2749 in the Technical Corrections Act of 1987. This bill could lead to substantial additional revenues for municipalities and I.R.S. which could benefit from cooperative information programs. Duplication of effort by both I.R.S. and Cities have lead to higher tax collection costs and loss of revenue for both the Cities and the Federal Government.

In the event that oral testimony is deemed desirable on H. R. 2749, I would appreciate the opportunity to participate.

Thank you in advance for your cooperation and assistance.

Respectfully submitted,

Oscar O. Kniceley
Oscar O. Kniceley
Commissioner of Taxation

CITY OF TOLEDO OHIO

DIVISION OF TAXATION
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PHILIP A. HAWKEY
CITY MANAGER

PATRICIA DeYOUNG
FINANCE DIRECTOR

RICHARD E. O'BRIEN
COMMISSIONER

CHARLES B. TAYLOR
TAX ADMINISTRATOR

June 25, 1987

Robert J. Leonard, Chief Counsel
Committee On Ways And Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: H. R. 2749 Amendment to Technical
Corrections Act of 1987 (H.R. 2636)

Dear Mr. Leonard,

Congresswoman Marcy Kaptur has recently introduced H. R. 2749 as an amendment to H. R. 2636, Technical Corrections Act of 1987. H. R. 2749 would allow municipalities with a population of at least 250,000 and a municipal income tax, to obtain data directly from IRS for the purpose of insuring compliance with the local income tax ordinance. There is currently a similar provision in federal law allowing cities with populations of 2,000,000 or more to obtain IRS data. The latter was part of an amendment sponsored by Senator Moynihan in a prior Technicals Corrections Bill. Thus, H. R. 2749 only adjusts the population threshhold required to qualify for the IRS data and does not make new law.

As the Commissioner of Taxation of the City of Toledo, I strongly urge inclusion of H. R. 2749 in the Technical Corrections Act of 1987. Its inclusion and passage would allow cities such as Toledo to recoup some portion of the revenue lost through the phase out of federal revenue sharing in 1986. Further, it will result in fairness to those taxpayers who have religiously paid their taxes over the years while other taxpayers failed to comply. The burden on IRS would be minimal as there are only about a dozen cities in the United States which have municipal income taxes and populations of 250,000 or more.

In the event that oral testimony is deemed desirable on H. R. 2749, I would like the opportunity to participate.

I thank you in advance for your consideration of these comments.

Respectfully submitted,

Richard E. O'Brien

Richard E. O'Brien
Commissioner of Taxation

Title XVI
Section 1603

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July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 2636 - Amendments to Title XVI

Dear Mr. Leonard:

This letter is in response to the request of the Ways and Means Committee for comments on H.R. 2636, the Technical Corrections Act of 1987. As you know, section 1603(a) of the Act added section 501(c)(25) to the Code, which exempts from tax a corporation or trust with a limited number of exempt shareholders or beneficiaries if it is organized for the purpose of "acquiring real property and holding title to, and collecting income from, such property". Under section 501(c)(25)(C), the shareholders or beneficiaries may be qualified plans, governmental plans, governments, or organizations described in section 501(c)(3). Section 1603(b) of the 1986 Act amended section 514(c)(9) of the Code by adding subparagraph (c)(iii), exempting income from real property held by a section 501(c)(25) organization from treatment as unrelated debt-financed income.

Section 116(a) of H.R. 2636 would modify the amendments made by section 1603 of the 1986 Act in several significant respects. First, section 116(a)(1) of H.R. 2636 would limit the type of real property that could be held by an organization described in section 501(c)(25) to direct interests, precluding ownership of real property through a partnership or as a tenant in common. We do not believe that this technical correction is justified by the applicable legislative history of the 1986 Act. On the contrary, the report of the Senate Finance Committee makes clear that the reason for enacting section 1603 was that "smaller, unrelated tax-exempt organizations should be able to pool investment funds for purposes of investing in real estate through a title-holding company". *See* S. Rep. No. 313, 99th Cong., 2nd Sess. 885 (1986). The common understanding of an "investment" in real estate would include investing in a partnership exclusively engaged in the acquisition and holding of real property. Why should entities be required to invest directly in real estate when investment through a partnership would be more efficient? The partnership approach would be particularly desirable when, as will be often the case, the owners of the section 501(c)(25) organization lack the expertise to acquire or manage real estate holdings.

Second, section 116(a)(5) of H.R. 2636 would add section 514(c)(9)(E) to the Code, providing that organizations otherwise qualified to be shareholders or beneficiaries of a 501(c)(25) organization shall nevertheless be treated as "disqualified holders" for purposes of section 514(c)(9). This would effectively repeal section 514(c)(9)(C)(iii) with respect to such shareholders or beneficiaries and cause their income from debt-financed real property to again become taxable. Among the entities with respect to which the benefits of section 514(c)(9) would be repealed are all organization exempt from tax under section 501(c)(3) (other than certain educational institutions), all governments, and all governmental plans, i.e., the vast majority of entities that were intended to be covered.

We can find no evidence in the legislative history that Congress intended to limit the benefits of the acquisition indebtedness exception to the narrow category of entities that would be allowed to benefit under H.R. 2636. Section 116(a)(5) is clearly not a technical correction, but a virtual repeal of an important substantive provision approved by the Conference Committee and by both houses of Congress. To repeal a substantive provision of the 1986 Act is inconsistent with the frequently stated positions of the Chairmen of the Ways and Means and Finance Committees that the Technical Corrections Act should not be a vehicle to undo the provisions of the 1986 tax reform.

For the foregoing reasons, we believe that the amendments proposed at section 116(a)(1) and 116(a)(5) of H.R. 2636 should be deleted. We would be pleased to discuss our reasons with you and to discuss less drastic alternatives for solving any problems that the Committee staff may perceive exist under section 501(c)(25) as originally enacted by Congress. Please feel free to give me or my colleague Bill Chip a call.

With best wishes.

Sincerely,

Donald C. Alexander

THE
CHILDREN'S
MEDICAL
CENTER

55 SHATTUCK STREET
BOSTON, MASSACHUSETTS 02115

July 9, 1987

Mr. Robert J. Leonard
Chief Counsel, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

If adopted by Congress, the Technical Corrections Bill of 1987 as reported by the Joint Committee on Taxation will have a dramatic adverse effect upon The Children's Medical Center, the parent organization of The Children's Hospital. The Bill purports to clarify the definition of holdings of real property by a so-called title holding company described by Section 501(c)(25) of the Internal Revenue Code of 1986 but, in fact, the Bill would prevent a Section 501(c)(25) corporation, affiliated with Children's, from participating in a joint venture or partnership and would cause such a corporation to have taxable income from ownership of debt-financed real estate. To assure that we can continue our mission of providing the best pediatric care available, it is sometimes vital to acquire real estate through a partnership with other organizations or individuals and to borrow for the acquisition of such property. Such activities may represent a sensible investment of our capital funds and, where the real estate is near the Hospital, as in our case, the acquisition of property may preserve our ability to meet future charitable goals.

The Bill purports to clarify the exception to the unrelated business taxable income rules of Section 514(c)(9) of the Code. Initially, no exempt institutions could invest in leveraged real estate. This was corrected several years ago, first for pension funds and then some years later for schools. The 1986 Act purported to put all charitable organizations described by Section 501(c)(3) on an equal footing with the schools and pension trusts by permitting any such organization to create a subsidiary qualifying as a Section 501(c)(25) title holding company which could invest in leveraged real estate without recognizing unrelated business income. We submit this is sound tax policy, and, when we learned of the remedial aspects of the 1986 Act, we acted upon the change in the law by reorganizing an existing corporation and creating a new corporation.

The Bill proposes that the tax law return to its pre-1986 status for purposes of the debt-financed taxable income rules. No charitable organization except a pension trust, school or affiliated organization will be permitted either directly or through a Section 501(c)(25) subsidiary to own any interest in debt-financed real estate for investment purposes without having taxable income. Any charitable organisation other than a pension trust, school, or an affiliated organization will be a so-called disqualified holder. In computing the unrelated business taxable income of the disqualified holder organisation, each stockholder of the Section 501(c)(25) title holding company will have its pro-rata share of income and expense attributed and taxed to it.

We believe that the proposed changes to Section 501(c)(25) and 514(c)(9) are not technical but are substantive and go considerably beyond the scope of the technical corrections that the Bill is intended to make. Treasury representatives have stated that no valid reason exists for treating schools more favorably than hospitals or other charitable organizations.

These changes did not appear in the Technical Corrections Bill which was proposed and nearly adopted by Congress in December, 1986. The changes are ill-advised, contrary to sound tax policy, and contrary to the intent and clear language of the provision as enacted into law last year. There had been no hint that Congress considered the relevant provisions of the 1986 Act as other than a correction of a past error at the time we organized our section 501(c)(25) corporation and transferred property to it. To reverse the relevant provisions under the guise of a "technical correction" is wrong; to do so retroactively is both wrong and unfair.

We request that your office make contact wiht the appropriate Treasury and Committee representative to request that the changes which Section 116 of the Bill would make in Sections 501(c)(25) and 514(c)(9) be eliminated. We appreciate your assistance in this important matter.

If you would like further information concerning the impact of the proposed change on Children's, please feel free to call me at (617) 735-6433 or John O. Wilhelm, Jr., Senior Vice President for Finance at (617) 735-6881.

Sincerely,

David S. Weiner
President

WRITTEN STATEMENT

OF

JAMES A. JOSEPH, PRESIDENT
COUNCIL ON FOUNDATIONS
1828 L STREET, N.W.
WASHINGTON, D.C. 20036

ON

H.R. 2636: THE TECHNICAL CORRECTIONS ACT OF 1987

Submitted To: The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives

MR. CHAIRMAN, members of the Committee, I am President of the Council on Foundations, a membership organization of over 1050 grantmaking institutions, holding assets in excess of $50 billion. Every one of these endowment dollars is permanently dedicated exclusively to charitable purposes, and as a national organization we are dedicated to assisting our members in managing those funds with care and diligence. Moreover, we seek to assist our members in finding ways within that duty of care to maximize their investment yields and thus provide more funding for charitable causes.

Section 501(c)(25) Organizations

The Tax Reform Act of 1986 created a new possibility for public charities -- including -- foundations to diversify their endowment portfolios by investing in Section 501(c)(25) real estate investment funds. Many members of the Council on Foundations have expressed strong interest in this new opportunity.

UBIT Exception and Section 116(a)(5)

It is our clear understanding of the full legislative history which added Section 501(c)(25) to the code that private foundations and community foundations would be able to join with pension funds in the ownership of real property through this new type of exempt organization. More specifically, foundations -- in so doing -- would not be subject to the unrelated business income tax (UBIT) if the Section 501(c)(25) organization uses debt to acquire its real estate. This exemption from UBIT already applies to pension funds and to certain colleges and universities. Without benefit of this exemption, this new investment opportunity becomes meaningless for foundations.

It is our understanding that Section 116(a)(5) of the Technical Corrections Act would repeal this exemption by subjecting non-university charities that are shareholders of a Section 501(c)(25) corporation to UBIT if the corporation uses debt to acquire or improve its real property.

We would submit that this proposed technical correction would frustrate the ability of public charities and foundations to participate actively in newly created Section 501(c)(25) corporations, and for these reasons we oppose this section of the Technical Corrections Act.

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WRITER'S DIRECT DIAL NUMBER
(212) 698- 2830

July 2, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Technical Corrections Act of 1987

Section 116(a)(5) of the Act, amending
Code Sections 501(c)(25) and 514(c)(9)

Dear Mr. Leonard:

On behalf of several members of the exempt organization community, I write to express deep concern about a proposed change in the unrelated business taxable income rules affecting debt-financed real property owned by tax-exempt Section 501(c)(25) title-holding companies. The changes proposed by Section 116(a)(5) of the Technical Corrections Act reverse a substantive provision of the Tax Reform Act of 1986 without providing an opportunity for substantive hearings.

The provisions affected by this proposal are found in Sections 501(c)(25) and 514(c)(9)(E)(iii) of the Code. Prior to the enactment of the 1986 Act, only pension funds qualified under Section 401(a) of the Code and educational organizations described in Section 170(b)(1)(A)(ii) were permitted to invest in debt-financed real estate without being subject to the tax on unrelated business taxable income under Sections 511 and 514. However, in Section 1603 of the Tax Reform Act of 1986, Congress created a new category of tax-exempt organization -- title-holding corporations or trusts organized for the exclusive purpose of acquiring and holding title to real property, collecting the income therefrom and remitting the income (less expenses) to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust. In a companion amendment, Congress provided that these new title-holding companies were to be exempt from the tax on debt-financed income under Code Section 514. Thus, because the permitted categories of shareholders of the new Section 501(c)(25) title-holding organizations included tax-exempt charitable organizations, Congress provided a mechanism to correct the inequitable and anachronistic distinction which had previously existed and to permit organizations described in Section 501(c)(3) to participate in leveraged real estate investments on the same basis as pension funds and universities.

There is ample -- indeed overwhelming -- evidence that Congress knew what it was doing when it enacted these provisions and that it intended the result which the statute now provides. To characterize the 1986 Act provisions as technically flawed makes a mockery of the explicit language of the legislative history of these sections. Thus, the co-sponsor of the provision (originally proposed as H.R. 3301), Congressman Robert Matsui, stated in his introductory remarks:

> "[T]his bill provides that section [501(c)(25)] organizations will be eligible for the acquisition indebtedness rules enacted in 1980 for pension plans, thus removing another inconsistency with respect to investment by tax-exempt organizations."

131 Cong. Rec. E 4025 (Daily ed. Sept. 12, 1985).

The Treasury Department agreed with this expression of intent, stating specifically that the purpose of the legislation was to extend the existing exemption to the debt-financed property rules to all qualified charitable shareholders of these new title-holding companies:

> "H.R. 3301 also would extend to collective real estate investment corporations the provision of current law that generally exempts certain real estate investments of qualified pension trusts and educational organizations from the debt-financed property rules. By extending the exception to such corporations, the bill indirectly would extend the exception to all organizations eligible to own beneficial interests in such corporations."

Miscellaneous Tax Bills, Hearings Before the Subcommittee of Select Revenue Measures of the House Ways and Means Committee, 99th Cong., 2d Sess. 190 (May 19, 1986). The Treasury Department testified that, "in their present form, the rules make an untenable distinction between educational organizations and other section 501(c)(3) organizations." Id.

Members of the exempt organization community are dismayed to find that a provision of the Tax Reform Act which Congress and the Treasury Department both supported and which, therefore, was not the subject of Congressional debate, is now arbitrarily threatened with extinction as no more than a clerical error. Nowhere in the Joint Committee's description of the proposed amendment is there any explanation -- or even an intimation -- of why or how this proposal cures an oversight or clerical error. No matter how its proponents attempt to describe it, this proposal is not a technical amendment; it is, instead, a profound and clearly substantive change in the provisions of the 1986 Reform Act.

Because it is substantive rather than technical, because it would perpetuate the inequitable and illogical distinction in the tax treatment of universities and pension plans, on the one hand, and charitable organizations, on the other, and because it contravenes the conscious and unambiguous intent of Congress in enacting Code Section 514(c)(9)(E)(iii), the amendment proposed in Section 116(a)(5) of the Act is inapproporate, indeed unjustified, as a "technical" correction of the 1986 Act. To permit the proposal to "slip through" unnoticed as part of an unprecedentedly voluminous technical correction act would violate the basic principles of candor, fairness and opportunity for hearing which are ingrained in our legislative processes. This provision should not be enacted.

Very truly yours,

Robert H M Ferguson

Robert H. M. Ferguson

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July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Submission for the Record on H.R. 2636
the Technical Corrections Act of 1987

Dear Rob:

On behalf of the General Electric Pension Trust, I am submitting the following comment on H.R. 2636, the Technical Corrections Act of 1987. The comment, as more fully described below, concerns the definition of "rents from real property" for purposes of the unrelated business income tax (UBIT) and for qualifying as a real estate investment trust (REIT).

Background

The Tax Reform Act of 1986 (Pub. L. No. 99-514)(the "Act") contained a provision that treats rents based on the net income of the tenant as "rents from real property" for purposes of meeting the REIT income requirements, provided that the tenant's profits are derived only from sources that the REIT would be permitted to earn directly (section 663(b) of the Act; Code section 856(d)(2) and (6)). Under prior law, such rents were not "rents from real property" for purposes of qualifying as a REIT. The purpose of the prior law limitation was to ensure that a REIT was a wholly passive investor in real property, and not an active business competitor with businesses that do not receive such conduit treatment (S. Rep. No. 1357, 93rd Cong., 2d Sess., reprinted at 1975-1 C.B. 517, 524 and H.R. Rep. No. 2020, 86th Cong., 2d Sess., reprinted at 1960-2 C.B. 819, 823).

Exempt organizations, such as pension trusts, face the same limitation on rents based upon the profits of the tenant as REITs previously did for similar reasons. Rents from real property are exempt from unrelated business income tax generally (Code section 512(b)(3)). However, if the rents are based upon the income or profits derived by any person from the leased property, the exemption does not apply (Code section 512(b)(3)(B)(ii)). Exempt organizations receiving rents based upon the tenant's profits are viewed as assuming the risks inherent in the particular business of the tenant, and thus as becoming engaged in a business generally unrelated to their exempt purpose. If, however, the income from the underlying business would be treated as exempt if received by the exempt organization directly, there is no reason to impose the UBIT simply because the income is received through an intermediary.

This is in fact the rationale for the change made to the REIT definition of "rents from real property" by the Act. The Senate Finance Committee report concluded that a REIT receiving rental income where the prime tenant's rent from the property depends only on rents received from the property is not participating in the profits of any active business other than that pertaining to the rental of its own property, even though the prime tenant's rent is based upon its net profits (S. Rep. No. 313, 99th Cong., 2d Sess. 776 (1986)).

Proposed Technical Correction

Pension trusts and other exempt organizations may also receive passive income through a prime tenant whose rent is based on its net profits from rents derived from subtenants. Since their inception, the UBIT rules exempting rents from real property that were not based on the income or profits of the tenant from tax have been linked to their REIT counterpart. When Congress enacted Code section 512(b)(3)(B)(ii) in the Tax Reform Act of 1969 (Pub. L. No. 91-172), it intended to maintain the distinction between passive and active business income, and purposely incorporated the test for "passive" rentals used for REITS into the UBIT rules (S. Rep. No. 552, 91st Cong., 1st Sess. 68-69 (1969)). Consistent with the Committee Report, the Treasury regulation implementing this part of the statute, Treas. Reg. Sec. 1.512(b)-1(c)(2)(iii)(b), references the rules contained in the regulations governing REITs, Treas. Reg. Sec. 1.856-4(b)(3) and (6). By failing to conform the definition of rents from real property for UBIT purposes, the Act has upset the long-established congruity between these two provisions.

Conformity could be reestablished by amending Code section 512(b)(3)(B)(ii) by inserting after the parenthetical ", except as provided in subparagraph (C)", by redesignating subparagraph (C) as subparagraph (D), and by adding the following new subparagraph (C):

> "(C) Clause (ii) of subparagraph (B) shall not operate to prevent the application of subparagraph (A) to amounts received by an organization if--
>
> > (i) an organization receives or accrues, with respect to real or personal property, amounts from a tenant which derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and
> >
> > (ii) such tenant receives or accrues, directly or indirectly, from subtenants only amounts which would be treated as rents excludable under this paragraph if received by the organization."

I appreciate the opportunity to comment upon this issue and the technical corrections legislation.

Sincerely,

Jayne

Jayne F. Boyle

Massachusetts
Eye and Ear
Infirmary

Office of the President

July 9, 1987

Robert J. Leonard
Chief Counsel, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

One proposed section of the Technical Corrections Bill of 1987 ("the Bill") as reported by the Joint Committee on Taxation will have a dramatic adverse effect upon Massachusetts Eye and Ear Infirmary, Inc. ("MEEI") if adopted by Congress. We need your assistance to prevent this effect.

Section 116 of the Bill purports to clarify the definition of holdings of real property by a so-called title holding company described by Section 501 (c) (25) of the Internal Revenue Code of 1986 but, in fact, the Bill would prevent a section 501 (c) (25) corporation, affiliated with MEEI, from participating in a joint venture or partnership and would cause such a corporation to have taxable income from ownership of debt-financed real estate. In order to acquire real estate in the area immediately surrounding MEEI to provide improved medical services to the community, it is frequently vital to acquire real estate through a partnership with other organizations or individuals and to borrow for the acquisition of such property. Such activities frequently represent a sensible investment of endowment funds and, where the real estate is near the hospital, as in our case, the acquisition of property to meet potential future charitable goals.

Section 116 of the Bill also purports to clarify the exception to the unrelated business taxable income rules of Section 514 (c) (9) of the Code. Initially, no exempt institutions could invest in leveraged real estate. This was corrected several years ago, first for pension funds and then some years later for schools. The 1986 Act purported to put all charitable orgainzations described by I.R.C. section 501 (c) (3) on an equal footing with the schools and pension trusts by permitting any such orgainzation to create a subsidiary qualifying as a section 501 (c) (25) title holding company which could invest in leveraged real estate without recognizing unrelated business income. We submit this as sound tax policy, and, when we learned of the remedial aspects of the 1986 Act, we acted in reliance upon the change in the law, organized a section 501 (c) (25) corporation and transferred certain real estate adjacent to MEEI to it.

243 Charles Street
Boston, Massachusetts 02114
617-573-3000

The Bill proposes that the tax law return to its pre-1986 status for purposes of the debt-financed taxable income rules. No charitable organization except a pension trust, school or affiliated organization will be permitted either directly or through a section 501 (c) (25) subsidiary to own any interest in debt-financed real estate for investment purposes without having taxable income. Any charitable organization other than a pension trust, school, or an affiliated organization will be a so-called disqualified holder. In computing the unrelated business taxable income of the disqualified holder organization, each stockholder of the section 501 (c) (25) title holding company will have its pro-rate share of income and expense attributed and taxed to it.

We believe that the proposed changes to Section 501 (c) (25) and 514 (c) (9) are not technical but are substantive and go considerably beyond the scope of the technical corrections that the Bill is intended to make. Treasury representatives have stated that no valid reason exists for treating schools more favorably than hospitals or other charitable organizations.

These changes did not appear in the Technical Correction Bill which was proposed and nearly adopted by Congress in December, 1986. The changes are ill-advised, contrary to sound tax policy, and contrary to the intent and clear language of the provision as enacted into law last year. There had been no hint that Congress considered the relevant provisions of the Tax Reform Act of 1986 as other than a correction of a past error at the time we organized our section 501 (c) (25) organization and transferred property to it. To reverse the relevant provisions under the guise of a "technical correction" is wrong; to do so retroactively is both wrong and unfair.

We request that your office make contact with the appropriate Treasury and Committee representatives to request that the changes which Section 116 of the Bill would make in Sections 501 (c) (25) and 514 (c) (9) be eliminated. A copy of that section is attached. Please call me if you would like additional information.

Sincerely yours,

E. Friedman

Ephraim Friedman, M.D.
President
Massachusetts Eye and Ear Infirmary

EF:dp

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July 17, 1987

By Hand

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act Proposed
Clarification of Code Section 501(c)(25)

Dear Rob:

This is to suggest that Act section 116(a)(4), which would amend Code section 501(c)(25) by adding a new subparagraph (F) to clarify the term "real property", should be expanded also to include ground leases within the definition of "real property".

I would, of course, be happy to discuss this with you or the appropriate member of your staff.

Sincerely,

Jerry

JLO/sr
cc: Mr. Daley

QualiCorp Inc.

A Growing Investment
In Aging America

June 30, 1987

Chairman Dan Rostenkowski
House Ways and Means Committee
The Capitol - Room 1102
Washington, D.C. 20515

Re: Technical Corrections Act
H. R. 2636 and S. 1350
IRC 501(c)(25)

Dear Chairman Rostenkowski:

Public comment regarding the above referenced technical corrections bill have been requested by the House Ways and Means Committee. Section 116 of the Bill would ammend sections 501(c)(25) and 514(c)(9) of the Code in a manner that would severely deminish the usefulness of 501(c)(25) for real estate entities. The very purpose for which it was created.

The reasons are:

(1) Section 116 would not permit a section 501(c)(25) organization to hold real property interests indirectly (such as through partnerships or another section 501(c)(25) entity) or even as a tennant in common; and

(2) Section 116 would treat a 501(c)(25) entity as a pass-through entity for the purposes of the debt-financed income UBIT exemption of section 514(c)(9), which means that if the [illegible] in real estate, a private foundation owning part of the entity would have UBIT taxable debt-financed income.

As you know, the 501(c)(25) investment vehicle was created by legislation in 1986 to mitigate the severe negative impact on the real estate industry created by the new tax law. It created a vehicle for 35 or fewer institutional investors (such as pension funds and foundations) to invest in real estate on an economical and prudent basis. These changes proposed by H.R. 2636 and S.1350 would eliminate the usefulness of 501(c)(25) with real estate for these pension funds and foundations. It would increase the cost for the retirement funds of the elderly to invest in prudent real estate properties. It would also have a severe negative impact on real estate values for existing properties.

The real estate industry, particularly here in Louisiana, has suffered enough blows in the past three years. Section 116 of these proposed bills would be another which we simply can't tollerate. Please consider removing section 116 from H.R.2636 and S. 1350.

Thank you for your help.

Sincerely,

John R. Runningen
Vice President
Institutional Investments

JR:gl

938 Lafayette St.
New Orleans, LA 70113
504 - 525 - 7000

WRITTEN STATEMENT OF PAUL SACK, PRINCIPAL, THE RREEF FUNDS
650 CALIFORNIA STREET, SAN FRANCISCO, CALIFORNIA 94108

COMMENTS ON SECTION 116 OF H.R. 2636 DEALING WITH SECTION 501(c)(25) CORPORATIONS

I. Background

The RREEF Funds are the largest group of closed-end, tax-exempt real estate investment funds in the United States. Since 1975. The RREEF Funds have provided an opportunity for pension plans and governmental plans to invest in a series of professionally managed, commingled, closed-end real estate investment funds. At this time, The RREEF Funds have over $3.0 billion subscribed or under management for exempt organizations.

Since the 1970s, The RREEF Funds have acted as the real estate adviser to pension and governmental plans that have pooled their investments through the use of a group trust. See Rev. Rul. 81-100, 1981-1 C.B. 326. A group trust is a pension trust described in section 401(a) that can have as beneficiaries only other pension trusts governmental plans and individual retirement accounts. See section 401(a)(24). The IRS National Office has extended tax-exempt status to a section 501(c)(2) corporation wholly-owned by a group trust. See G.C.M. 38253 (Jan. 23, 1980).

The group trusts organized and managed by The RREEF Funds have invested in institutional quality real estate such as shopping centers, office complexes and industrial parks. The group trusts hold title to and manage these properties so as to generate little, if any, unrelated business income. Thus, the group trusts' principal source of income is rentals from real property and incidental personal property. The group trusts managed by The RREEF Funds have never been formed to invest in personal property unrelated to real estate such as stocks and bonds or computers.

There are three primary shortcomings to the group trust as an investment vehicle for tax-exempt entities. The first is the limitation on eligible investors in the group trust. Tax-exempt foundations, religious institutions, endowments, museums, hospitals and other organizations exempt under section 501(c)(3) cannot invest in group trusts. Throughout the years, The RREEF Funds had been compelled to turn down requests to manage real estate for universities and private foundations because such organizations could not participate in a group trust.

Second, under local law each pension plan may be considered the direct co-owner of the real property owned by the group trust. This means that each pension plan may be liable for any injury or accident occurring on the property for an unlimited amount. Given the state of the insurance industry, it is often prohibitive or impractical to obtain as much insurance as much as one might like for these risks, and therefore under the present arrangement a pension plan could sustain a loss even exceeding its total investment in a group trust. Pension plans and investors of all sorts often prefer to use a corporate entity as the vehicle for their investment because under state law the corporation provides limited liability, i.e., each plan would be liable only to the extent of its corporate investment.

The third problem concerning group trusts centers on transactions involving the unrelated business income tax ("UBIT"). This separate tax does not apply to certain income items such as dividends, interest and certain real property rents unless the exempt organization incurs debt to acquire or improve the property generating such income items. If it holds such "debt-financed property," the exempt entity is taxed on a portion of the income generated by the leveraged property pursuant to section 514.

In 1980, Congress added section 514(c)(9) permitting any trust described in section 401(a) such as a group trust to acquire real property subject to leverage without owing any unrelated business income tax so long as several stringent conditions are met. Such conditions serve to prevent the benefits of this exception to the acquisition indebtedness rules from being passed on to the seller of the property acquired by the qualified trust. For example, the exception only applies if the acquired property is not leased back to the seller and the property is not acquired from a party related to the qualified trust or any participant in the qualified trust. Congress extended this exception to the acquisition indebtedness rules to certain educational institutions in 1984.

Section 514(c)(9) solved the problem faced by a group trust when it acquired property subject to existing debt at favorable rates or debt that could not be paid off without a significant prepayment penalty. However, the benefits of this section do not apply to a group trust's section 501(c)(2) subsidiary. See, e.g., Private Letter Ruling 8326173. Thus, prior to the 1986 Act it was impossible to achieve simultaneously the protection of limited liability and the treatment granted by section 514(c)(9). Also, section 501(c)(3) charities could not participate in a group trust.

II. Legislative History

A. 98th Congress

To address these inequities, Senator Packwood and Congressmen Matsui and Archer introduced legislation in the 98th Congress that would have allowed up to 35 pension plans, governmental retirement plans, governmental units and charities described in section 501(c)(3) to invest in an exempt corporation that would qualify for the exception to the debt-financed property rules applicable to pension plans.

The Subcommittee on Taxation and Debt Management of the Senate Finance Committee held a hearing on Senator Packwood's bill (S. 1815) on September 26, 1983. Testifying on behalf of the The RREEF Funds, a Morrison & Foerster partner explained why the Treasury Department at that point opposed S. 1815:

> As I understood, the Treasury testimony basically made two points:
>
> First, with respect to the unrelated income tax point, they say that they never liked it in the first place, Congress should never have extended [the exception to the acquisition indebtedness rules to] pensions, and since they didn't like it in the first place it shouldn't go any further; although they admit in their testimony that the distinction between pensions and other tax-exempt institutions, section 501(c)(3), educational institutions and foundations, is as they say "tenuous."

> Senator Packwood. Yes. They would be very happy if we repealed the pension exemption.
>
> Mr. Silberman. My view as a matter of public policy and my clients's view as a matter of public policy, as the institution which operates and provides an investment vehicle for these institutions, is that there is no distinction between the two-- the 501(c)3's on the one hand and the pensions on the other, and I think Treasury recognizes it.
>
> So the Congress really has two choices: One, do you repeal the provision for the pensions, which Congress is never going to do? Or, two, do you rationalize it by giving the same benefits to the educational institutions and foundations?
>
> And in a time of budget-cutting on the part of the Government, it seems almost absurd to suggest that the Government does not have an interest in increasing the corpus of educational institutions and foundations which perform much of the work that the Government otherwise would do if it had more funds. So that's No. 1 with respect to the Treasury's objection to extending the unrelated business income tax beyond pensions to educational institutions and foundations and the corporations which [S.] 1815 would set up to do that.
>
> . . .
>
> Senator Packwood. I think your point is well taken, and, Mr. Silberman, you are right, we are not going to repeal the exemption for pensions. You can picture the yell that would go up if we start down that road. So we start with premise-A -- that is not going to change.
>
> Clearly I think it is unfair competition, one. Two, the purposes that this bill is directed to are clearly in the public interest; Treasury doesn't even argue that in terms of who we are trying to benefit.

1983-84 Miscellaneous Tax Bills--VII, Hearing Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, 98th Cong., 1st Sess. 158-59 (September 26, 1983).

Clearly, this quotation shows that Senator Packwood thought that it was unfair that pension plans could incur debt to acquire real property without being taxed, while section 501(c)(3) charities could not. His legislation (which was dropped from DEFRA in conference but, on the section 514(c)(9) issue, incorporated intact by last year's Finance Committee bill) remedied this by allowing a collective investment corporation to qualify for the acquisition indebtedness exception on the entity level so that its charitable shareholders could indirectly benefit to the same extent as its pension plan shareholders.

B. 99th Congress

After consulting with the Treasury Department to address its concerns with the legislation that was not adopted as part of DEFRA, Congressmen Matsui and Archer co-sponsored H.R. 3301 in the 99th Congress. Like its predecessor in the 98th Congress, H.R. 3301 expressly amended Code section 514(c)(9) to extend the exception applicable to pension plans to the new collective investment corporation at the entity level. As stated in Congressman Matsui's introductory remarks:

> [T]his bill provides that section 501(c)(24) organizations will be eligible for the acquisition indebtedness rules enacted in 1980 for pension plans, thus removing another inconsistency with respect to investment by tax-exempt organizations.

131 Cong. Rec. E 4025 (Daily ed. Sept. 12, 1985).

Senator Wallop introduced the companion bill, S. 1808, with an identical intent. Senator Wallop stated:

> As a result of the recent piecemeal changes in tax laws regarding real estate investment by tax-exempt groups, opportunities currently available only to the largest of them are not within reach of the smaller ones. Pension trusts, government plans and educational institutions are allowed, because of amendments to the code made in 1980 and 1984, to invest in leveraged real estate without being held liable for taxes on the income produced thereby, but the smaller organizations such as private foundations and charities are not able to take advantage of this.
>
> * * *
>
> The legislation I introduce today would correct inequities and expand the opportunities to these organizations to invest in real property by creating a new corporate investment entity free of current restrictions. . . . [Emphasis added].

131 Cong. Rec. S 14458 (Daily ed. Oct. 30, 1985). Clearly, Senator Wallop introduced this legislation to allow all Section 501(c)(3) charities to take advantage of the Section 514(c)(9) exception by investing in a Section 501(c)(25) corporation.

Obviously, the inconsistency in the UBIT rules would not have been resolved if the UBIT exception were applied on the shareholder level because some shareholders would be subject to tax while others would not. This is why H.R. 3301 and S. 1808 used an entity level test.

The following year, Congressman Matsui asked Chairman Rostenkowski to refer H.R. 3301 to the Subcommittee on Select Revenue Measures for a hearing so that it could be considered as part of the tax reform bill. Again, Congressman Matsui's intent on the UBIT issue was precise. In a letter to the Chairman dated February 18, 1986, Congressman Matsui stated:

> Amendments in 1980, 1982 and 1984 permitted pension trusts, governmental plans and educational institutions to invest in leveraged real estate without incurring taxable income as a result; this opportunity remains foreclosed to other tax-exempt organizations such as private foundations and charities.
>
> H.R. 3301 will provide a new investment vehicle that will treat tax-exempt entities equally with respect to debt-financed real estate transactions.

Again, the method by which H.R. 3301 achieved this goal was to extend the exception to the acquisition indebtedness rules to a section 501(c)(25) corporation at the entity level so that all qualified exempt shareholders would not be subject to UBIT if the corporation invested in leveraged real estate.

At the hearing before the Select Revenue Measures Subcommittee held on May 19, 1986, all witnesses who testified on this issue expressed their clear understanding that charitable shareholders of a section 501(c)(25) corporation would not be subject to UBIT if the corporation used debt to acquire or improve real estate. Indeed, some organizations premised their support of H.R. 3301 upon this very idea.

The Treasury Department, which had opposed the predecessor legislation introduced in the 98th Congress, acquiesced to H.R. 3301 and expressed its understanding of the section 514(c)(9) change as follows:

> H.R. 3301 also would extend to collective real estate investment corporations the provision of current law that generally exempts certain real estate investments of qualified pension trusts and educational institutions from the debt-financed property rules. By extending the exception to such corporations, the bill indirectly would extend the exception to all organizations eligible to own beneficial interests in such corporations.
>
> On several prior occasions, the Treasury Department has testified that the debt-financed property rules should not be narrowed. . . .
>
> Several developments subsequent to our prior testimony have caused us to alter our position regarding expansion of the exception to the debt-financed property rules. . . . Our acquiescence in this narrowing of the debt-financed property rules is based on our judgment that, in their present form, the rules make an untenable distinction between educational organizations and other section 501(c)(3) organizations [emphasis added].

Miscellaneous Tax Bills, Hearings Before the Subcommittee of Select Revenue Measures of the House Ways and Means Committee, 99th Cong., 2d Sess. 190 (May 19, 1986). In addition, the Treasury Department suggested that section 514(c)(9) be further amended to extend the UBIT exception to direct real estate investments by a charity. Id.

The organizations that commented on H.R. 3301 reiterated Treasury's understanding of H.R. 3301. The RREEF Funds testified that:

> The bill would also extend to these section 501(c)(25) corporations the exemption from the unrelated business income tax on debt-financed property currently extended to pension trusts, governmental plans, and certain educational institutions, thereby correcting the unfair treatment of investments by other exempt organizations such as foundations, religious institutions, museums, and nonprofit hospitals which currently do not qualify for this exemption.
>
> . . .
>
> The collective investment entity under H.R. 3301 would allow tax-exempt organizations to pool their resources without the restrictions imposed under current law, including the acquisition indebtedness rules that now apply to charities but not to pension plans, governmental plans or educational institutions.

Id. at 274-75.

Other organizations submitted statements in support of H.R. 3301 that expressed a similar understanding of the intent underlying the Code section 514(c)(9) change. For example, the Pension Real Estate Association stated:

> The bill also would exempt these [section 501(c)(25)] organizations from the unrelated business tax on debt-financed income pursuant to rules that currently apply only to qualified plans and certain educational organizations. PREA supports the removal of this inconsistency in current law which treats various types of tax-exempt organizations differently.

Id. at 374.

Several charitable foundations also sent letters to the Subcommittee in support of this provision. For example, the Richard King Mellon Foundation wrote:

> The proposed Bills would permit foundations to indirectly become equity owners of leveraged real estate without incurring the unrelated business income tax. As you are aware, the Internal Revenue Service has already accorded pension funds and educational institutions this status. We view this as a very significant factor from an investment standpoint because the use of debt (particularly when an investor can assume existing debt at lower rates) can enhance investment returns. We strongly

recommend that this portion of the legislation not be deleted during any hearings.

In addition, a report was prepared by a recognized economics analysis firm that calculated the revenue impact of H.R. 3301 on the assumption that the only revenue loss would occur because the Code section 514(c)(9) exception applicable to pension plans would apply to non-university charities for the first time. Id. at 368-73. The revenue estimators at the Joint Committee on Taxation and the Treasury Department told the economics analysis firm that the only revenue loss generated by H.R. 3301 and S. 1808 resulted from the fact that, for the first time, private foundations and other non-university charities would qualify for the exception to the debt-financed property rules.

Finally, Congressman Matsui's statement submitted for the record repeated his earlier-stated intent to remove the inconsistent UBIT treatment of tax-exempt organizations. Id. at 366-67.

S. 1808 was adopted by the Senate and accepted by the House conferees as section 1603 of the Tax Reform Act of 1986. The above legislative history leaves no doubt that Congress intended to extend the section 514 exception to a section 501(c)(25) corporation at the entity level so that all of its qualified shareholders would not be subject to UBIT if it invests in leveraged real estate.

III. H.R. 2636

A. Debt-Financed Rules

Section 116(a)(5) of H.R. 2636 (the Technical Corrections Act of 1987) would reimpose the inconsistent treatment under prior law. Under this proposed change, any non-university charitable shareholder of a section 501(c)(25) corporation would be subject to UBIT if the corporation invests in leveraged real estate. This proposed change would contradict the clear legislative intent summarized above and would go well beyond the scope of a technical correction.

If the proposed statutory amendment were to go into effect, a non-university charity likely would not invest in real estate with pension plans, governmental plans or universities through a section 501(c)(25) corporation because a leveraged investment would result in a tax on the charity but not on the other shareholders. Any such result would frustrate the clearly expressed Congressional intent of permitting all section 501(c)(3) charities to pool their real estate investments with other types of exempt organizations on an equal basis.

This proposed rule would create an intolerable conflict of interest among shareholders of a section 501(c)(25) corporation that would lead investment advisers like The RREEF Funds to exclude private foundations and other charitable institutions from the section 501(c)(25) corporations they sponsor. Otherwise, when the investment adviser uses leverage to maximize the fund's return pursuant to its fiduciary responsibility mandated by ERISA, the charitable shareholders would be subjected to UBIT.

One wonders why Congress would permit charitable organizations to be shareholders of a section 501(c)(25) corporation if they would be singled out as the only type of shareholder of a section 501(c)(25) corporation that does not qualify for the UBIT exception. The above legislative history evidences the opposite Congressional intent which H.R. 2636 would reverse without cause.

Last, this proposed change to section 501(c)(25) would again raise artificial distinctions between universities on the one hand and other charities on the other. As Senator Packwood stated in the 98th Congress and as Congressman Matsui and Senator Wallop stated in the 99th Congress, there is no justifiable policy reason why universities should receive the same debt-financed property exception as pension plans while foundations, museums, nonprofit hospitals, religious institutions and other charities do not.

Enactment of section 116(a)(5) of H.R. 2636 is contrary to clear Congressional policy adopted in 1986 and would be a significant step backward. We urge the Committee to let section 514(c)(9) stand as currently written.

B. Joint Ventures

Section 501(c)(25) corporations must own only "real property." Section 116(a)(1) of H.R. 2636 would exclude from the definition of real property "any interest as a tenant in common (or similar interest) and shall not include any indirect interest." The Joint Committee pamphlet accompanying H.R. 2636 states:

> This rule ensures a consistent application of the intent of section 501(c)(25) that a title-holding company is required to hold real property directly and cannot, for example, treat an interest in a partnership, trust, or other entity as an investment in real property.

Description of the Technical Corrections Act of 1987, JCS-15-87 at 280 (June 15, 1987).

Nothing in the legislative record suggests that section 501(c)(25) corporations should be prevented from owning indirect interests in real property. In fact, just the opposite.

The Senate Finance Committee Report states that it adopted this new provision because:

> smaller, unrelated tax-exempt organizations should be able to pool investment funds for purposes of investing in real estate through a title-holding company, with the same tax treatment as is available under present law to a larger tax-exempt organization having as a title-holding subsidiary that is tax-exempt as an organization described in section 501(c)(2).

S. Rep. No. 313, 99th Cong., 2d Sess. 885 (1986).

Without a doubt, this quotation shows that section 501(c)(25) corporations were intended to be have as least as much flexibility in making its investments as a section 501(c)(2) corporation owned by a large exempt organization such as a group trust. Otherwise, the two types of title-holding companies would not receive the same "tax treatment."

The IRS acknowledges that a section 501(c)(2) corporation may hold a partnership interest. See, e.g., G.C.M. 39597 (Jan. 22, 1987). Specifically, the IRS routinely issues determination letters to section 501(c)(2) corporations owned by group trusts when the articles of incorporation expressly empower the corporation to acquire co-ownership interests. For no compelling reason, H.R. 2636 would impose a different "tax treatment" on a section 501(c)(25) corporation that invests in a partnership.

Section 1603(b) of the 1986 Act added section 501(c)(25) corporations to the list of "qualified organizations" under section 514(c)(9). Because this exception to the acquisition indebtedness rules only applies to acquisitions of "real property," section 514(c)(9) serves as the best evidence of how Congress intended such term should be construed for purposes of section 501(c)(25).

Under section 514(c)(9)(b)(vi), a qualified organization may obtain the benefit of section 514(c)(9) if it enters into a partnership that acquires real property. For these purposes, a qualified organization is considered as acquiring real property that is actually acquired by the partnership. This "look-through" rule is consistent with the general principles underlying Subchapter K as well as with the treatment of partnerships owning real property as real property for purposes of the REIT rules. See Treas. Reg. § 1.856-3(g).

Section 116(a)(1) of H.R. 2636 also would impede the goal of a section 501(c)(25) corporation from achieving the maximum amount of geographic and functional diversity. Put simply, premium real estate of the type acquired by exempt commingled funds are very expensive. Acquiring co-ownership interests provides an excellent method of diversifying the number of properties a fund owns, the geographical locale of such properties and the types of such properties.

Without the ability of entering into co-ownership arrangements, a section 501(c)(25) corporation might be faced with the choice of either incurring unwanted debt to finance additional acquisitions or owning a smaller number of properties that may not satisfy the ERISA-imposed fiduciary requirements. Further, some types of premium real estate properties may not be acquired by fee simple. For example, developers of regional shopping malls virtually always retain a minority interest in regional shopping malls.

There is no apparent policy reason for forbidding a section 501(c)(25) corporation from making these real estate opportunities. If the concern is that the 35-shareholder limit may be avoided by using partnerships, a simple attribution rule adopted by regulations will suffice. Cf. Prop. Treas. Reg. § 1.1361-1A(e)(1) (stock held by tenants in common or joint tenants is considered to be owned by each co-owner for purposes of the 35-shareholder rules for S corporations).

The proposed statutory amendment in section 116(a)(1) would restrict the operation of section 501(c)(25) corporations unnecessarily and should not be adopted.

C. Subsidiaries

Under current law, one section 501(c)(25) corporation can be a shareholder in another section 501(c)(25) corporation. See section 501(c)(25)(C)(v). This provision was added by the conferees after The RREEF Funds pointed out that group trusts typically create a new section 501(c)(2) company for each property it acquires. This way, any unforeseen liability arising on one property will not affect the group trust's investment in the other properties because of the corporate characteristic of limited liability under state law. Cf. Rev. Rul. 76-335, 1976-2 C.B. 141.

Section 116(a)(3) of H.R. 2636 would delete section 501(c)(25)(C)(v) and instead would treat a section 501(c)(25) corporation as directly owning the assets of its wholly-owned subsidiaries. The Joint Committee pamphlet explains that this change would be made "to implement the 35-person limitation on shareholders or beneficiaries of a section 501(c)(25) organization. . . ." See JCS-15-87, supra at 280.

As stated above, no statutory amendment is needed to enforce the 35-shareholder limitation because the Treasury Department has sufficient regulatory authority to impose attribution rules. Further, the proposed amendment would cause serious problems.

The structure paralleling the group trust/title-holding companies structure would be imperilled by the proposed change because the wholly-owned subsidiaries of a section 501(c)(25) corporation would not be exempt for federal tax purposes and therefore likely will be treated as taxable corporations for state tax purposes. Several states such as New York and Texas have recently passed legislation specifically exempting section 501(c)(25) corporations and many other states such as Illinois automatically exempt organizations that receive an IRS determination letter. However, such local actions would be negated by section 116(a)(3) of H.R. 2636 because no section 501(c)(25) corporation would be willing to establish subsidiaries if they are subject to state or local taxation.

In addition, the proposed change would prevent a section 501(c)(25) corporation from acting as the vehicle for a joint venture for qualifying exempt organizations. The group trusts such as those for which The RREEF Funds serve as investment adviser often enter into a partnership with a governmental retirement plan to jointly invest in a specific property. A section 501(c)(25) corporation would be the ideal vehicle for this joint venture because of its limited liability. However, H.R. 2636 would prevent a commingled section 501(c)(25) corporation from doing this because it could not acquire an interest in another section 501(c)(25) corporation. There is no reason for this prohibition so long as the number of shareholders in the commingled section 501(c)(25) corporation plus the governmental plan is not greater than 35.

Section 116(a)(3) of H.R. 2636 is another example of a substantive provision that has no place in technical corrections legislation.

Section 1605

Testimony On Behalf Of

University Patents, Inc.

Before

The Committee on Ways and Means
U.S. House of Representatives

On

The Technical Corrections Act of 1987, H.R. 2636

Submitted By F. David Lake, Jr.

July 17, 1987

This written testimony is submitted in response to press release #12, dated June 10, 1987, of the Committee on Ways and Means soliciting testimony on proposals to increase revenues.

University Patents, Inc. proposes that Congress repeal section 1605(c) of the Tax Reform Act of 1986 or amend it in technical respects as outlined below in order to correct a continuing and, we believe, unintended abuse created by that section.

Background

Technology transfer organizations are companies that assist universities in marketing the products of research they have sponsored. University Patents, Inc. is a small for-profit technology transfer organization located in Westport, Connecticut. It has subsidiaries in Largo, Florida and Urbana, Illinois. University Patents' principal competitors are Research Corporation of Tucson, Arizona, which is organized as a private foundation, and a newly-formed company to which Research Corporation has transferred its technology transfer business (the "technology transfer organization").

Enactment of Section 1605(c)

During conference on the Tax Reform Act of 1986, Research Corporation succeeded in having a provision added to the bill, section 1605(c). This provision allows it to fund a new company which operates as a taxable nonprofit corporation, without being subject to any of the private foundation regulatory taxes that would otherwise apply under the Internal Revenue Code. The provision was not in either the House or the Senate bill and received little or no scrutiny before being added to the Tax Reform Act. It is not a transition rule, as it does not relate to any other provision of the Act, but is a substantive provision applicable to a single company.

Consequences of Section 1605(c)

Section 1605(c) of the Tax Reform Act of 1986 permitted Research Corporation, a private foundation, to transfer its technology transfer business and investment assets, net receivables, and cash not exceeding $35 million to a new taxable nonstock entity for "debt." The transfer was exempted from the private foundation regulatory excise taxes that are designed to safeguard against this type of potentially abusive transaction. Those taxes include the tax against self dealing which normally would prevent a loan of this nature (certainly any loan at a below market rate of interest), the tax on taxable expenditures which normally would prohibit the transfer of assets to an organization that is not exempt and, most importantly, section 507(c) of the IRC which normally would prevent assets being removed from private foundation "solution" without the repayment of tax benefits obtained while the organization was exempt.

The provision in effect allowed Research Corporation to set up a "non-private private foundation" (somewhat analogous to a nonbank bank) -- an organization that is funded with untaxed private foundation dollars yet is beyond the reach of the private foundation regulations. The new entity has a significant competitive advantage over its taxpaying competitors because its multimillion dollar "core capital" was built up without the payment of any income tax. In addition, since the new taxable entity is a nonstock corporation, it does not have to pay dividends like a normal corporation and the "interest" it pays on the so-called debt gives it a deduction for a dividend equivalent. This result does violence to the private foundation and unrelated business taxable income provisions of the Internal Revenue Code.

Possible Solutions

There are two possible solutions to correct the ongoing abuse caused by section 1605(c). One of the solutions should be incorporated in the Technical Corrections Act of 1987.

First, section 1605(c) should simply be repealed and the assets of the newly-formed corporation should be required to be returned to Research Corporation where the activities of the technology transfer business once again would be subject to the private foundation regulations and any investment income again would be subject to the 2 percent tax on net investment income under section 4940 of the Internal Revenue Code.

Second, in the absence of repeal, the following technical amendments should be made in an attempt to mitigate the continuing unfairness:

1. The first technical correction would define the term "debt" for purposes of section 1605(c)(2)(A) by requiring that any debt obligation pay interest at least annually at the "applicable federal rate" (as defined in section 7872(f) of the Code) and amortize the principal in substantially level payments (not less frequently than quarterly) over the life of the obligation. It is inconsistent with debt status for the obligation to bear interest at less than a market rate and to be repaid in a balloon payment (which could be rolled over into another long-term obligation) at the end of a long maturity period. It also is inconsistent with the private foundation rules for the transferor private foundation to receive less than a market rate of interest.

2. The second technical correction seeks to cure the potential Clay Brown abuse (a taxable entity sheltering its income with deductible payments that are not taxable income to the recipient exempt organization) by providing that interest paid or payable by the technology transfer organization would not be deductible. This provides a measure of equity with taxpaying competitors which pay nondeductible dividends by, in effect, treating payments by the technology transfer organization to the private foundation as nondeductible constructive dividends. Moreover, the technical correction provides some compensation for the unfair advantage of the technology transfer organization receiving a transfer of a startup fund from an exempt organization that is several times the size it would have been if income taxes had been imposed in accordance with the Code.

3. The third technical change would require the private foundation to treat the interest received as unrelated business taxable income. The circumstances of the creation of the technology transfer corporation as the mirror image of the private foundation indicate that it is de facto a controlled corporation. Moreover, Washington Research Foundation, 50 TCM 1457 (1985), holds that the carrying on of a technology transfer business has a substantial commercial purpose and hence is an unrelated trade or business if carried on by an exempt organization. Thus, the technical amendment would amend section 512(b)(13) of the Code to provide that the technology transfer organization is treated as a controlled organization and the ratio of interest treated as UBTI is 100 percent.

Section 1608

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July 9, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the National Association of Collegiate Directors of Athletics ("NACDA"), I wish to respond to the opportunity to submit comments on H.R. 2636, the Technical Corrections Act of 1987.

NACDA wishes to express its views on Section 116(b) which repeals Section 1608 of the Reform Act. It is NACDA's position that rather than "rolling-back" the two institutions identified in Section 1608, the Technical Corrections Act ought to "roll-up" all collegiate athletic programs, by overturning Revenue Ruling 86-63.

Background

Revenue Ruling 86-63 itself was issued on April 28, 1986, in an effort to "clarify, distinguish, and supercede" an earlier Revenue Ruling (Rev. Rul. 84-132) which had raised questions about any contribution tied into collegiate athletic ticket purchases. In fact, what the new Revenue Ruling did was to continue the total disallowance of contributions in sold-out stadiums and raise significant evaluation and administrative questions in other facilities.

In the 99th Congress, an amendment to roll-back Revenue Ruling 86-63 was introduced by Senator Pryor on the very day that the Ruling was issued. Shortly thereafter, in the House of Representatives, the same bill was offered by Representative Dicks. Moreover, in the course of consideration of the Tax Revision Bill, Senator Symms drafted a much more comprehensive overturning of the effect of the Revenue Ruling. Conference Committee efforts by Senator Long and Representative Pickle to obtain relief for all of college athletics from the impact of the Revenue Ruling were unsuccessful. Unable to achieve that broad exemption, Senator Long and Representative Pickle -- in an effort to express the bad policy behind the Ruling -- sought some relief for their "constituent institutions" -- Louisiana State University and the University of Texas. Subsequently, House Concurrent Resolution 335 proposed to strike Section 1608, but was never passed.

In the 100th Congress, Senator Gramm has introduced S.74 and Representative Pickle has introduced H.R. 1106, both of which would extend the exemption from Revenue Ruling 86-63 to all schools.

Need For The Legislation

It is estimated that approximately $125 million is contributed yearly to Preferred Seating Plans at some 150 colleges and universities around the country. It is believed that approximately three-quarters of all major athletic programs are involved with Priority Seating Plans. The Plans enable donors to buy preferential seating at collegiate sporting events. Revenue Ruling 86-63 totally disallowed certain contributions and raised significant evaluation and administrative questions in other facilities.

Two principal problems emerged from the Revenue Ruling: Contributions tied into ticket purchases in sold-out stadiums were denied completely as a deduction and the administrative problems attached to non-sold-out stadiums were so chaotic that both schools and taxpayers ignored the law.

Substantively, as a result of the position of the Internal Revenue Service, there ultimately will be a significant diminution of contributions, thereby injuring not football and basketball (those sports usually associated with the Plans), but non-revenue and women's sports.

(a) Administrative Chaos

The college Athletic Directors have made a compelling case that the Ruling simply creates extreme administrative problems. It is apparent that the IRS just did not understand the collegiate sports industry and how the Ruling would affect it. Among these:

* Since a sold-out facility triggers a "death penalty" of no deduction whatsoever, universities will begin holding back tickets for day-of-game sale where a stadium or arena is normally sold out.

* Some universities tie tickets into gifts to the university, rather than to the athletic department, raising much broader policy questions.

* The IRS did not realize that contributions tied to ticket purchases are made, not on a one-time basis, but on a yearly basis, thereby creating annual administrative problems.

* The vast bulk of plans -- approximately 85% -- involve a "grandfathering" problem, where a $300 per year contributor may be sitting next to a $1000 per year contributor sitting next to a $500 per year contributor sitting next to a $50 per year contributor -- all based on when they joined the plan. This factor apparently was not considered by the IRS.

* Since each solicitation must identify the specific amount which can de deducted, a university may be called upon to examine every ticket purchased in a Priority Seating Plan. And this could be required every single year, based on changing factors. One university, for example, would be required to make a yearly analysis of the 17,000 participants in its Plan because of the grandfathering problem.

* A university deciding to use a flat percentage does not meet the specifics of the Revenue Ruling which requires an analysis of

> the level of demand for tickets, the general availability of seats, the relative desirablity of seats based on their types, locations, and views, and other relevant factors.

- An institution that decides to use a *flat amount* (e.g., $75 per ticket) *throughout the entire facility* likewise would not meet the specifics of the Revenue Ruling. Moreover, using that across-the-board $75 evaluation, our hypothetical grandfathered contributors now have the following deductions:

Contributor	Contribution	Non-Deductible	Deductible
A	$ 300	$75	$225
B	$1000	$75	$925
C	$ 500	$75	$425
D	$ 50	$75	[$25 in imputed income?]

- Exacerbating this situation, the IRS obviously did not consider a very common problem that arises with collegiate basketball tournaments and most football programs. Collegiate basketball tournaments, like the Atlantic Coast Conference Tournament, the Big Ten Tournament, the Big East Tournament, and so forth, have become stellar, sold-out events. In the ACC, for example, one cannot even hope to get access to a Tournament ticket, unless you are one of the season ticket holders at one of the ACC schools. Given that fact, each ACC school is required to make the first-cut allocation as to how much of the contribution should be attributed to access to a Tournament ticket (or the possibility of obtaining a Tournament ticket) and allocate the rest to regular season. Of course, the amount attributable to the sold-out Tournament is totally non-deductible -- but what is it worth? The same type of situation occurs in football when School A, for example, might expect to sell-out the School B game, but not the School C contest.

- Some sports, such as hockey, defy the ability to set standards for the benefit received, since there is no commonly-accepted view of what are the best seats.

- The schools face a Catch-22: If the institution estimates the non-deductible portion of the contribution too *high*, it runs the risk that a donor will be much more wary of giving, since less will be deductible. On the other hand, if the institution values the benefit too *low*, it runs an even greater risk that the donor might be audited as a result of advice of the institution.

- It is the successful program -- those that sell tickets --that are the most subject to injury under it. A university that might sell out both its football and basketball home games will find itself telling its contributors that no part of any contribution is deductible; on the other hand, the unsuccessful programs that don't work at selling tickets don't have to worry about non-deductibility of charitable contributions. An equally anomalous result occurs if one institution's football season is sold out, but basketball is not. The college is put in the position of telling contributors to football that their contribution is *not* deductible, while a contribution to basketball *is* deductible, creating confusion in gift-giving.

(b) Policy Rationale

Ultimately donations will be reduced as a result of the ill-conceived policy. This will have various impacts.

- Charitable contributions -- imperative to fund non-revenue (i.e. minor and women's) athletics -- will drop significantly if they cannot be written off. A University of North Carolina study showed that more than 50% of donors to athletic programs identify tax considerations as "very important" or "important" in their giving.

- Since most college athletic programs are required to be fully funded from their own activities, any shortfall as a result of reduced contributions will be made up by going to the institution's General Fund; this in turn will be funded by the taxpayers generally. Alternatively, the shortfall will result in the dropping of certain athletic programs, which generally will be non-revenue minor sports and/or women's athletics. As a result of the financial crisis, schools have already begun dropping sports.

- The legislative resolution is limited in its scope -- and therefore in its revenue impact. At the specific request of Representative Pickle, an examination was made of legal, economic, and policy implications of expanding the charitable contribution bill to cultural events. See letter of February 9, 1987. It was concluded that other Industries simply are not affected in the same way as collegiate athletic Preferred Seating Plans, that no cultural "preferred seating programs" existed, that the economics were totally dissimilar, and that those industries have the ability to "expand their capacity" by more performances, a solution not available to college football, for example. We concluded:

> ...[T]he expansion of the scope of [the legislation] may raise questions that do not have to be raised in the economics of an industry [cultural events] that has not sought and will not necessarily benefit from the additional exemption.

For the above reasons, the National Association of Collegiate Directors of Athletics respectfully requests the expansion, not the contraction (or repeal), of Section 1608 of the Tax Reform Act.

Sincerely,

Philip R. Hochberg

Title XVII
Section 1701

July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Submission for the Record on H.R. 2636
Regarding a Technical Correction to
Eliminate Retroactive Certification
of Employees for Purposes of the WIN Credit

Dear Rob:

On behalf of C.I.C. Enterprises, Inc. and Government Program Services, Inc., employment consulting firms that assist taxpayers with respect to WIN and targeted jobs tax credits, we are submitting the following comment on H.R. 2636 regarding a technical correction to eliminate retroactive certifications of employees for purposes of the WIN credit. The comment, as more fully described below, points out that our suggested correction, which is currently embodied in H.R. 2111, introduced by Chairman Rostenkowski, represents an equitable compromise by effecting a technical change in the law that should increase future tax revenues while providing only prospective termination of a practice that taxpayers have justifiably relied upon.

Background

Under sections 40 and 50A(a),1/ employers were allowed a credit, subject to certain limitations, equal to the sum of 50 percent of the first-year "work incentive program expenses" and 25 percent of the second-year "work incentive program expenses." Section 50B(a) provided that the term "work incentive program expenses" meant "the amount of wages paid or incurred by the taxpayer for services rendered by "eligible employees." Section 50B(h)(1) defined the term "eligible employee" as an individual (emphasis added) --

---

1/ All section references are to the Internal Revenue Code of 1954, as amended.

> (A) who has been certified by the Secretary of Labor or by the appropriate agency of state or local government as--
>
> (i) being eligible for financial assistance under part A of title IV of the Social Security Act as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or
>
> (ii) having been placed in employment under a work incentive program established under Section 432(b)(1) of the Social Security Act,

* * * *

The statute itself contained no requirement that employee certifications be obtained prior to employment. Similarly, the legislative history of section 50B(h)(1) is devoid of any suggestion of a requirement that employee certification be obtained prior to employment. Thus, it seems clear that the credit is available if an otherwise eligible employee is certified at any time before the claim for the credit is ultimately allowed by the Internal Revenue Service.

The Internal Revenue Service, in two private letter rulings, acknowledged that certifications obtained after employment were valid for purposes of the targeted jobs tax credit (the "TJTC") under section 51, which contained certification requirements very similar to those in section 50B(h)(1):

> "A review of the targeted jobs credit history shows that initially there was no provision concerning the timeliness of certifications. The SESAs were allowed to issue certifications to employers retroactively even if the employer did not request the certification before the individuals began work. . . ." PLR 8414024 (December 30, 1983) (emphasis added). Similarly, PLR 8432065 (May 8, 1984).

Because the WIN credit was almost identical to the TJTC, section 261(g)(1)(B) of the Economic Recovery Tax Act of 1981 ("ERTA"), P.L. 97-34, 1981-2 C.B. 256, 304, added WIN registrants to the list of target groups covered by the TJTC by providing that WIN registrants be added to the list of target groups, but only for tax years beginning after December 31, 1981. In addition, ERTA section 261(c)(1)(A) amended section 51 to require that certifications be obtained prior to employment for purposes of the TJTC, but provided a transition period during which employers could obtain valid certifications for employees hired prior to the passage of ERTA. No similar requirement or transition period was enacted with respect to the WIN credit for taxable years beginning before January 1, 1982. The failure of Congress to enact similar rules for WIN credits claimed under sections 40, 50A and 50B for taxable years beginning prior to January 1, 1982, suggests that Congress did not desire to change retroactively the WIN credit certification requirements.

The Joint Committee Explanation of ERTA (i.e., the "Blue Book") reiterates the tax act's statutory language in more generic terms by providing that the WIN credit is merged into the TJTC for amounts paid or incurred in taxable years beginning after December 31, 1981. Accordingly, for taxable years beginning before January 1, 1982, the pre-ERTA WIN credit provisions (sections 40, 50A and 50B), and not the TJTC provision (section 51), continue to apply in regard to both the computation of the WIN credit in the first and second years of employment and the certification requirements for qualified employees hired during that time.

In General Counsel's Memorandum (G.C.M.) 36904, published on March 11, 1987, the Office of the Chief Counsel of the Internal Revenue Service has taken the position that certification of employees prior to employment was required under section 50B as it was originally enacted. G.C.M. 36904, however, does not satisfactorily explain the basis of this contention and does not even discuss the relevance of the new pre-employment certification requirement added by ERTA. The G.C.M. therefore provides a misleading and incomplete analysis of the WIN credit law with respect to employee certifications.

Taxpayers have relied upon the fact that the WIN credit provisions were not retroactively amended by ERTA and have filed claims for WIN credits for which they justifiably believe they are entitled. We are aware that many of these taxpayers have had their claims approved by the Internal Revenue Service, while others are currently being denied.

H.R. 2111

As introduced by Chairman Rostenkowski, H.R. 2111, would codify the position taken in G.C.M. 39604 that the WIN credit is not available with respect to any employee for whom the employer did not request or obtain certification on or before the date the individual commenced work for the employer. However, the bill would make this change effective only for WIN credits first claimed after March 11, 1987, the date G.C.M. 39604 was first published.

H.R. 2111 would apply for purposes of the WIN credit the principle that Congress passed in ERTA with respect to the TJTC. In so doing, the bill would prevent taxpayers from claiming previously available WIN credits and therefore would produce additional tax revenues. At the same time, the bill, by making the amendment effective only for credits first claimed after March 11, 1987, recognizes the reliance that taxpayers have placed on the availability of the WIN credits and the lack of a transition period (such as that provided by ERTA for the TJTC).

We appreciate the opportunity to comment upon the technical connections legislation.

Sincerely,

Jerry Cohen

N. Jerold Cohen
Sutherland, Asbill
& Brennan

John [illegible]. Salmon
Dewey, Ballantine, Bushby,
Palmer & Wood

Section 1703

A&T

A. C. & T. Co., Inc.
ROUTE 2, BOX 377
HAGERSTOWN, MARYLAND 21740
—
(301) 582-2700

July 14, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski,

As a petroleum marketer I feel that it is of utmost importance that I write you concerning the gasoline excise tax collection. Under Section 1703, my company would lose its right to collect and remit the gasoline excise tax. We have been operating in this manner since 1959 and the proposed change would create a very serious cash flow problem. To compound the problem, serious competitive imbalances would be created. Financially resourceful major oil companies would be able to manipulate or control small businessmen as myself much more effectively.

It is extremely important that this bill be amended in order for we independent businesspeople to maintain our viability. I am confident that I am speaking for many other marketers in making this request. I urge you to consider the negative implications of passing this bill. Under Section 1703, this bill would eventually lead to the demise of many marketers such as myself. I urge you to consider my position and allow my company to remit taxes to the Federal government as it has for many years.

Your consideration of this matter is greatly appreciated.

Sincerely,

A. C. & T. CO., INC.

Adna B. Fulton
President

ACORN PETROLEUM, INC.
An Ochs Brothers Enterprise
76 S. Sierra Madre St. • At the Depot
P.O. Box 603
Colorado Springs, Colorado 80901

PHONE
634-8874

July 7, 1987

The Honorable Dan Rostenkowski, Chairman
Commmittee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Re: Section 1703 - Technical Corrections Bill

Dear Chairman Rostenkowski:

We are a family owned business in our 30th year. We market gasoline and diesel fuel to a number of customers in the major cities in Colorado. We provide employment to approximately 100 people. We are substantial tax payers to local, state and the federal government.

We take great pride in the positive impact our relatively small business has in our several communities. We are a fairly typical petroleum marketer.

Our future, however, is not terribly bright. We are faced with severe impact from several government programs. Underground storage tank insurance, expensive leak detection systems, stage II vapor recovery, D.O.T. mandated truck and trailer upgrades, mandated payroll benefits, and other major costs are apparently headed our way from Washington.

This long list of government mandated major capital costs comes at a time when our ability to fund these costs is questionable. Our profits in 1987 and for the past 4 years have been badly eroded by very tough competition from the much larger integrated oil companies. These companies are our suppliers and our competitors. They have subsidized their losses in marketing from their profits in crude oil through 1985. In 1986 refining was quite profitable for much of the year when crude oil costs fell faster than gasoline and diesel selling prices did.

Chairman Rostenkowski, we don't expect you to solve all of our problems. We ask you to keep from tilting our playing field even more in favor of the integrated oil companies. We ask that changes in Section 1703 be made that would allow independent marketers to continue to pay the Federal Fuels Excise Tax -- but on gallons purchased, rather than on gallons sold.

If this change is not made as we are requesting; businesses such as ours will have serious cash flow problems and competitive inbalance will tilt in favor of our suppliers - the integrated oil companies.

Please help,

Harlan L Ochs

Harlan L. Ochs,
President

The Atlas Oil Company

414 TOLLAND STREET, EAST HARTFORD, CONN. 06108
TELEPHONE (203) 289-6435

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I urge you to support ammending Section 1703 of the 1986 Tax Reform Act which would allow my company the right to continue to collect and remit the Federal Excise Tax on gasoline.

By taking away our ability to collect and remit this tax, the stage would be set for all of our suppliers (the major oil companies) to gain an unfair advantage in the marketing of gasoline in Connecticut -- it is tough enough competing with them without the creation of this additional burden.

Also keep in mind that my family-owned business has collected and remitted excise taxes to the federal government for the past thirty years and every dollar is accounted for.

Our national organization, PMAA, has a plan that will give us what we need to stay in business and yet comply with the collecting process under the new law.

Please keep the small legitimate independent gasoline jobber in the petroleum distribution system.

Sincerely yours,

Irwin B. Singer
President

B-B-F OIL COMPANY, INC.
5506 JEFFERSON PARKWAY
PINE BLUFF, AR 71602

July 2, 1987

The Honorable Dan Rostenkowki
Chairman, Ways & Means Committee
House of Representatives
Washington, D. C. 20515

Subject: Gasoline Tax Collection & Remittance Rights
For Small Independent Distributors

Dear Congressman Rostenkowski,

Your support is solicited, in amending Section 1703 of the 1986 Tax Reform Act, so that marketers would retain the right to remit the tax to the treasury.

As you know, Section 1703, which is scheduled to take effect on January 1, 1988, would shift the right to collect and remit the federal gasoline excise tax from marketers (small independent businessmen - such as myself) to refiners and terminal operators.

Your past interest and efforts for small business has shown your sensitivity for our needs, and I bring this to your attention because it will effect every small business (gasoline distributor) in our nation, who currently holds Federal Gasoline Tax Permit.

The Industry Press has been full of abuses committed by Gasoline Distributors in the collection of gasoline taxes, especially on the east coast. Yes, there are some sinners amoung the Distributors in this nation! However, does history reveal the REFINERS to be all that pure? Dare I mention the crude oil refunds, or even the new book "OIL & HONOR"?

We Small-Business (Gasoline Distributors) who currently hold Federal Gasoline Tax Permits, benefit from the service which we render (as unpaid tax collectors) in 2-ways;

1) Cash Flow, the Federal excise tax on gasoline is payable semimonthly, by the 14th day after the close of the semimonthly period. Example: a small-business selling 1 million gallon of gasoline per month, at .09 cents per gallon tax, will have approximately $45,000.00 in cash flow working at all times.

2) The Federal excise tax on gasoline is paid upon sales, consequently, the small-business does not have to pay .09 per gallon on evaporation.

Your assistance solicited and appreciated.

Sincerely,

William Ferren

William L. Ferren

BALLANCE OIL CO.
WEST SECOND STREET
RUSSELLVILLE, KY. 42276

TIRES

July 6,1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

SUBJECT: Technical Corrections Needed To Section 1703 Of The Tax Bill Passed In 1986

Dear Sir:

This letter to let you know that we strongly support Rep. Pickles' proposed amendment to revise Section 1703 of the Tax Reform Act passed in 1986.

We are small Shell jobbers, the last home owned, home operated jobbership in Logan County, Kentucky. To lose our privilege to report and remit Federal excise tax on gasoline will not be just an "impact," its going to be a "calamity".

We have had a permit since January 1960 and we will put our record of prompt and correct payment on the line as evidence that those who have good records should be allowed the privilege to continue to report and remit Federal excise tax on gasoline.

Yours very truly,

BALLANCE OIL CO., INC.

William H. Ballance, President

HUOT OIL
BARON-HUOT OIL COMPANY
SINCE 1911
P.O. BOX 602 · KANKAKEE, IL 60901-0602 · (815) 933-3365

June 26, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman Rostenkowski;

Section 1703 of the Tax Reform Act of 1986 will have dire effects on petroleum marketers. While I applaud the effort to find a way to end tax cheating, the proposed changes treat marketers unequally and create other areas of concern.

Marketers,like myself, will have a loss of cash flow while my supplier-marketer, with whom I compete, will not. This puts me at a greater competitive disadvantage. The issue could even worsen if there isn't an allowance given for shrinkage. Doesn't ethanol blended gasoline create a different problem for tax collection? And isn't it possible that my supplier, also a marketer and my competitor, could gain a further advantage as a tax collector?

The uncertanies, the imbalance and the cost to marketers of this legislation make it unacceptable. In order to eliminate tax evasion and maintain credibility with the petroleum marketing community I suggest you simply enforce the code as it exists. That may result in the need to hire additional personnel, procedure changes and maybe even using state Departments of Revenue to assist in auditing the federal excise tax.

As proposed the small , honest marketer will pay heavily for an untested method some think will curb tax evasion.

Yours Truly,

Bruce Huot

Post Office Box 486
505 Creekway Drive NW

BEALL OIL COMPANY

Lenoir, North Carolina 28645
(704) 758-4401

June 29, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

As a distributor of gasoline and diesel fuel, I am writing to express my concern about changes in the method of exise tax collection under Section 1703 of the Tax Reform Act of 1986. For the past four years my company has collected gasoline and diesel exise taxes and forwarded them to the IRS thru deposits at a local bank.

I am concerned about these changes for two reasons. First, they will give a competitive advantage to the major oil companies with whom I compete and second, they will have a negative effect on the cash flow of my business. Operating a distributorship such as mine is no easy task under the best of conditions. The changes that Section 1703 will bring will have an adverse effect on all petroleum marketers and I strongly urge you and your committee to ammend Section 1703 to eliminate the competitive imbalances created by it.

Sincerely,
BEALL OIL COMPANY

John B. Beall

John B. Beall
President

Fuel Oil Gasoline Kerosene Diesel Fuel Industrial Oils & Lubricants

belcher oil co. inc.
p. o. box 88
murray, kentucky
42071

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Represenatives
Washington, DC 20515

Subject: Technical Corrections needed to Section 1703 of the Tax Reform Bill Passed in 1986

Dear Sir:

On January 1, 1988 all petroleum marketers will lose their right to collect and remit Federal Excise Tax on gasoline. I strongly feel and support that taxes be paid on gallonage purchased rather than gallons sold in an effort to eliminate tax evasion and fraud.

However, it is important that the technical Correction Bill be changed to allow the marketers to continue to collect and remit the tax. If their Suppliers are allowed to collect the tax; then those Suppliers would have the benefit of increasing their competitive position in the market place.

By doing this the marketer would be at a great disadvantage. When you change the competitive picture between the supplier and marketer, when that supplier is competing in the marketplace, you will drastically reduce the competitivness by the small marketer.

I hope you consider the impact on the small business and vote in favor of changing the bill.

Thank you for your time and consideration on this matter.

Sincerely,
BELCHER OIL CO., INC.

J. Brad Belcher

BENEDICT & BENEDICT, INC.

Glasgow - 651-5212
Horse Cave - 773-4200
Scottsville - 237-3376

P.O. Box 181
103 E. College St.
Glasgow, Ky. 42141

June 29, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

SUBJECT: Technical Corrections Needed to Section 1703 of the Tax Reform Bill passed in 1986.

Dear Sir:

As a petroleum marketer, I want to advise you that the change presented in the right to collect and remit federal excise tax on gasoline will be catastrophic to a large portion of petroleum marketers across this country. This change would create financial hardship for the individual marketers while increasing the financial advantage of the direct marketing suppliers.

This would necessitate many to have to borrow extra operating capital to pay taxes ahead of present guidelines, decreasing profits or increasing losses, at a time when more operation capital is needed to meet other federal requirements.

Our margins are very slim as it is and this requirement can make a major difference.

Consider the impact that this will have on all small petroleum businesses throughout the United States.

Sincerely,

BENEDICT & BENEDICT, INC.

Carroll S. Benedict, President

GCGASCARD
The Total Fuel Marketing Program

ATLAS
TIRES • BATTERIES • ACCESSORIES

July 3, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways & Means
2111 RHOB
Washington, D.C. 20515

Dear Senator,

Once again the home owned small business is the target of costly proposed regulations under the Federal Tax Reform Bill of 1986. The proposal requires jobbers to pay the refiner excise tax at time of purchase of product instead of local jobber paying excise tax direct to the Federal Government.

This new regulation would move the money immediately out of our area into the hands of the refiner who would then have use of the money without a single advantage to the Federal Government. Can you justify sending that tax money to another state?

Collection of Federal excise tax by the refiners-not good for Illinois - home owned business - or the Illinois economy.

Sincerely,

Dennis M. Corkery

Dennis Corkery
Manager Big Ten Mart
East Dubuque, Illinois 61025

BLOCK OIL COMPANY, INC.
P.O. BOX 152 - 736 SECOND STREET
WEBSTER CITY, IOWA 50595
(515) 832-1457

July 1, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Sir:

Section 1703 of the Bill passed last year becomes law as of January 1, 1988. This Bill takes away our right to remit gasoline excise tax directly to the IRS and creates a great hardship on Independent Petroleum Marketers.

We are in direct competition with our suppliers and large oil company direct marketers. One advantage we Independent Marketers have, which allows us to be in competition with these companies is collecting and remitting our own gasoline excise taxes, because it gives us cash flow. This bill removes the advantage we have and puts the advantage of our purchases in the hands of these large oil companies. A serious cash flow problem could occur for us if this bill is not corrected.

A potential competitive imbalance could happen if the small Independent Petroleum Marketers cash flow is cut so substantially he can not remain in business. This would leave only the large oil companies in the petroleum marketplace.

We feel the only alternative to this dilemma is to allow the Independent Marketer to continue to remit the gasoline excise tax as they are now - - but on gasoline gallons purchased rather than on gallons sold - - directly to Internal Revenue Service. This would make it possible for the government to audit taxable gallons more easily from information given them by the suppliers of the product and still help the small businesses remain sound.

Sincerely,

Russell D. Block

Russell D. Block, President
BLOCK OIL COMPANY, INC.

BOB RILEY DISTRIBUTORS INC.
"Central KY Chevron Jobber"
Boggs Lane • Richmond, Kentucky 40475
Lexington: 253-3340 • Richmond 623-4032

July 4, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Subject: TECHNICAL CORRECTIONS NEEDED TO SECTION 1703 OF THE TAX REFORM BILL PASSED IN 1986.

Dear Sir:

As you are aware, January 1, 1988 all Petroleum Marketers will lose the right to collect and remit federal excise tax on gasoline. I strongly support that taxes be paid on gallons purchased rather than gallons sold in an effort to eliminate all tax fraud. However, it is urgent that in the Technical Corrections Bill there be a change to correct and allow the marketers to continue to collect and remit the tax. If our suppliers are allowed to perform this function, then our suppliers will have the benefit of increasing their competitive position in the marketplace on a direct marketing basis. This betterment of their competitive condition will ~~be to~~ the detriment of all marketers and put us in an unfavorable profit situation which we will not be able to control. This will also put our suppliers in a better position to monopolize the selling of petroleum products in the marketplace.

I would appreciate your serious consideraton to the impact that you will have on all small petroleum businessmen throughout the United States and would hope that you would support this technical correction in the Technical Corrections Bill.

Respectfully Yours,

Bob Riley

(618) 282-2344

AMOCO
JOBBER PRODUCTS

Braun Oil Co.
R. R. 1 - Box 26A
Highway 3 South
Red Bud, Illinois 62278

July 8, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

This letter is being written with great concern about the Technical Corrections Bill (H.R. 2636 and S. 1350). Revisions to Section 1703 of the Tax Reform Act of 1986 are strongly needed. If we lose our right to collect federal tax, it will greatly impair the growth and profit of our business.

Section 1703 was drafted hastily, without an assessment of the competitive imbalances it creates. Marketers suffer a loss of cash flow while their suppliers, with whom they compete, do not, leaving marketers at a competitive disadvantage in the marketplace. Section 1703 needs to be revised if these serious competive imbalances are to be remedied. The National trade association representing petroleum marketers, PMAA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same time preserving the protections against tax evasion established in Section 1703.

Why not allow a refinery to sell to the licensed distributor tax free, and the licensed distributor will be allowed to resell only on a tax paid basis. This would stop the avoidance of federal excise taxes.

If this federal excise tax on gasoline is to be paid to the refinery, it is very important that the rule include a provision that the tax invoice, that the jobber will receive allow ten days for payment.

Please consider my comments concerning this matter and urge your colleagues to add the PMAA's proposed amendment.

Thank you very much.

Sincerely,

Carl J. Braun

Carl J. Braun

BROADUS OIL CORPORATION

1006 WEST MAIN STREET • STREATOR, ILLINOIS 61364
TELEPHONE 815-673-5515

June 25, 1987

THE HONORABLE DAN ROSTENKOWSKI
Chairman
Committee of Ways and Means
2111 RHOB
Washington, DC 20515

Re: Technical Corrections Bill

Dear Mr. Rostenkowski:

As an oil distributor in central Illinois we are writing this letter urgently requesting that you make revisions to Section 1703 of the Tax Reform Act of 1986 so that we can remain on a competitive basis with our suppliers. If the present bill is passed as is, we will suffer a severe loss of cash flow, while our suppliers, with whom we compete every day, will have still another competitive advantage over us. I can not see how the bill can cover our ethanol/gasoline blends, of which we are 100% usage. The bill as is does not have provisions for product purchased on a gross gallon basis rather than net gallon basis. Also the present bill does not seem to have a provision for shrinkage, or a loss in gallons due to temperature changes. It seems that the bill was drafted rather hastily with no consideration taken of the competitive imbalances that it will create.

Being a director of a local bank I am seriously concerned as to the loss of deposits that the bill in its current form will cause to Illinois banks. These tax deposits monies that are now being used in local banks in Illinois to make loans for new business and improvements would be lost to the larger banks in other states. As an representative from the State of Illinois I would hope that you would share my concerns. This bill as is will severely cut the cash flow of companies such as ours, and there fore decrease the available deposits being made to Illinois banks.

The national trade association representing petroleum marketers, PMMA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same time preserving to the greatest extent possible the safeguards against tax evasion established in Section 1703. I am requesting that you review this proposal and give it your support.

Best regards,

L. Paul Broadus

L. Paul Broadus
President

Browning Oil Company

BOX 808 • BOWLING GREEN, KENTUCKY 42101 • TELEPHONE 842-2454 AREA CODE 502

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

SUBJECT: Section 1703 of the Tax Reform Bill in 1986

Dear Sir:

I have been concerned for some time that the Tax Reform Bill as passed last year levies an unfair burden on small gasoline and diesel fuel marketers/jobbers in that we would no longer be able to collect the motor fuel tax as we purchase it from our suppliers and remit the tax ourselves.

I realize that you have a problem with some few who have committed fraud and not reported their tax liability over time. However, in the thirty-four years we have survived in the jobbing business, we have NEVER failed to collect and report, and pay for fuel taxes. To change this procedure and require that we pay the taxes to our suppliers, who would then have the collection time is grossly unfair and uncompetitive for us.....we compete with these companies directly in the marketplace.

As our profits are squeezed, we cannot compete with this unfavorable situation.

I would urge that your committee strongly consider this problem and ask that we continue to collect and pay the tax to the Federal government, such remedy being made in the Technical Corrections Bill.

Thank you,

Dave Browning

Dave Browning,
JOBBER

SERVICE IS OUR BUSINESS

CERTIFIED

CERTIFIED OIL COMPANY

303 SOUTH FRONT STREET • COLUMBUS, OHIO 43215 • PHONE: (614) 224-3175

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Ways & Means Committee
House of Representatives
Washington, DC 20515

Dear Chairman Rostenkowski:

I strongly urge that section 1703 of the 1986 Tax Reform Act be amended to allow marketers to retain the right to remit the Federal Excise Tax to the Treasury.

To force marketers to pay the tax immediately upon purchase of gasoline from refiners gives the major oil companies a price advantage because of the increased cash flow.

David J. Hogan

David J. Hogan
Controller
Certified Oil Company

CHATHAM OIL COMPANY

PHONE (804) 432-0251 • P. O. BOX 879 • CHATHAM, VIRGINIA 24531

July 9, 1987

Honorable Dan Rostenkowski, Chairman
Committee on Ways & Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Rostenkowski:

As a petroleum jobber I am seriously concerned about a provision in the Tax Reform Act of 1986 which will prohibit our company from collecting and remitting the federal gasoline tax as of January 1, 1988. I am a small business petroleum wholesaler located in the Commonwealth of Virginia. I am registered to collect and remit the federal excise tax on gasoline and have done so for many years without any loss to the U.S. Treasury.

The 1986 provisions will force our company to buy gasoline tax-paid from our major oil company suppliers, with whom we are also frequently forced to compete due to the complexity of the channels involved in the U.S. gasoline distribution system. The provisions will aggravate the problems of financing inventory and receivables that our company is already experiencing because of rising gasoline prices. Cash flow problems will also be made tougher.

We are told that the reason for the inclusion of the provision in the Tax Reform Act of 1986 was to prevent tax evasion. We have heard that the IRS and the U.S. Treasury Department say that they are unable to prevent evasion by auditing a long trail of tax free sales of gasoline between registered tax collectors prior to a sale to an unregistered purchaser, at which point the tax would have to be applied.

We believe we have a solution to the tax evasion problem, which would allow most Virginia jobbers to continue to function as registered tax collectors. Petroleum Marketers Association of America (PMAA), with which our company is affiliated, has come up with a proposal to allow marketers to remit taxes on purchases from a supplier, rather than on sales to customers, and there would be no tax exempt sales downstream. This would shorten the audit trail considerably, and allow IRS auditors to determine readily if tax evasion has occured, by matching a marketer's reported purchases with the sales total reported by his supplier. (In Virginia, our Department of Motor Vehicles is able to audit much more complicated series of transactions without difficulty.) The PMAA proposal also calls for marketers to demonstrate financial responsibility for two payment periods up to $150,000, to provide extra insurance against loss of gas tax liability to the U.S. Treasury.

We urge you and the other members to your committee to give favorable consideration to the PMAA proposal during your deliberations over the technical corrections to the 1986 Tax Reform Act.

The ability to continue to buy tax free from the major oil companies is crucial to the viability of some of our members and to the maintenance of a competitive gasoline market in Virginia and throughout America.

Sincerely,

Ben Davenport

Ben J. Davenport, Jr.
President
Chatham Oil Company

CHILES OIL, INC.
P. O. BOX 330
PULASKI, TENNESSEE 38478
615/363-5561

July 2, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Congressman Rostenkowski:

I must point out to you one part of the tax reform bill I take the strongest objection to! It is the change in the collection procedure of the Federal Excise Tax on gasoline motor fuel.

Presently my company is allowed to collect the tax and remit to the government twice a month. Come January 1, 1988, we will be required to remit the tax when we purchase the fuel from our supplier who, of course, can pay as we presnetly do, twice a month, to the government.

This change greatly changes the competition balance in the market place.

It will take about $27,000 out of our working capital (available cash) and give it directly to my supplier for his use!

It is a further penalty in that we must, under the new rules, pay on gallons purchased not on gallons sold as now. Evaporation and product loss is unavoidable in product handling. We, not the consumer, must pay the tax on the lost product. Of course big oil pays only on sales as before.

In addition to cutting our working capital substantially my supplier may decide our credit line with him is insufficient to cover the higher dollar purchases due to the federal taxes. We will then have to restrict our purchases and as a result what we sell or pledge added security to my supplier. A double whammy!

Our industry like almost no other has our major suppliers as our major competition! To give my supplier this much of an edge could run my small business out of the market place. I believe government's job is to provide as level a playing field as possible and that small business is a vital part of our economy. I hope you agree.

You are in the position of being able to correct this injustice. Please allow the recommended changes in Section 1703 of the tax bill suggested by the Petroleum Marketers Association of America.

Sincerely yours,

CHILES OIL, INC.

W. Bruce Chiles

CLINE
OIL COMPANY, INC.
1920 South Main St. - Harrisonburg, VA 22801
Telephones:
1-(703) 434-3892
1-(703) 434-4404

June 29, 1987

Honorable Dan Rostenkowski, Chairman
Committee On Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski,

I am writing to you both as a small businessman and as a member of the Virginia Petroleum Jobbers Association Board of Directors. I urge you to support an amendment to the Tax Reform of 1986 which would allow oil jobbers to continue to collect and remit the federal gasoline tax. The amendment was explained in a letter addressed to you from the Virginia Petroleum Jobbers Association dated June 24, 1987. I agree wholeheartedly with the letter.

As a small business we are constantly bombarded with new legislation concerning underground tank leaks, vapor recovery, retirement plans, and immigration laws to name but a few. All of these laws are very expensive and extremely time consuming. There comes a limit to how much more small businesses can shoulder.

Cline Oil Company has been collecting and remitting federal gasoline taxes to the government for years and have never missed a payment. I resent the fact that I will be forced to pay the gasoline taxes up front because a few criminals are cheating the system. I employ at least one extra employee due to our tax collection responsibility and have spent thousands of dollars on computer programing to handle the administration of the taxes. Now, we will be forced to borrow a large sum of money to finance the collection of these taxes. The additional capital requirements in turn impede our ability to grow in our community.

We also will find ourselves at a further competitive disadvantage with major oil companies. We compete daily with these giants who frequently sell gasoline at their stations for less than our product costs. The prepaid gasoline tax requirement could give the majors up to a one cent additional competitive advantage.

Please give this matter your support. The bill is unfair to the small, honest oil jobbers.

Sincerely,
CLINE OIL COMPANY, INC.
Paul S. Cline
Paul S. Cline

Coulson Oil
Company, Inc.

jobber
Shell Oil
products

1434-38 Pike Avenue
P. O. Box 68
NORTH LITTLE ROCK, ARKANSAS 72115
(501) 376-4222

July 13, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Dear Honorable Rostenkowski:

The current issue of the Federal Gasoline Excise Tax Collection Procedure is of importance to me. The Technical Corrections Bill (HR 2636/S. 1350) needs to include an amendment. I support amending Section 1703 of the 1986 Tax Reform Act so that marketers of PMAA can continue to remit the federal excise tax on gasoline as we have for thirty years.

Otherwise, on January 1, 1988, remittance of this tax will shift to my supplying refiner, principally Shell Oil Company. The negative impact to my cash flow will be $150,000.00.

Thank you for your support.

Sincerely,

Michael B. Coulson
President

Fuel for modern living

Daniel Baker Oil Company, Inc.
RURAL ROUTE 6, BOX 1
MANCHESTER, KENTUCKY 40962
TELEPHONE (606) 598-2411

Quality Gasoline
Diesel Fuel and Oil Jobber

Support our COAL Industry
It supports Us!

WM. A. HENSLEY
PRESIDENT

DAVID J. HENSLEY
MANAGER

July 7, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski,

We urge that revisions be made to Section 1703 of the Tax Reform Act of 1986. We support these revisions because of the following:

1. Section 1703 was drafted hastily, without an assessment of the competitive imbalances it creates;

2. Marketers suffer a loss of cash flow while their suppliers, with whom they compete, do not, leaving marketers at a competitive disadvantage in the marketplace;

3. Section 1703 needs to be revised if these serious competitive imbalances are to be remedied; and

4. The national trade association representing petroleum marketers, PMAA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same time preserving to the greatest extent possible the protections against tax evasion established in Section 1703.

Thank you for your time.

Sincerely,

William A. Hensley

GOLDEN CIRCLE CENTER
BOX 360
ANKENY, IA 50021
(515) 964-6725

DATAGAS

July 10, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representative
Washington, D. C. 20515

RE: Federal Gasoline Excise Tax Collection Procedure

Dear Congressman Rostenkowski:

This is in regard to Section 1703 of the 1986 Tax Reform Act which would shift the right to collect and remit the federal gasoline tax from the marketers to refiners and terminal operators.

I feel there is a definite need for steps to be taken to end excise tax evasion but feel evasion can be eliminated without adversely affecting the legitimate marketers who have remitted excise taxes to the Federal Goverment for the past thirty years.

DATAGAS, Inc. is a new instant access, self-service gasoline marketer based in Iowa. Section 1703 would create serious cash flow problems for us as a new business trying to get into the marketplace.

Another concern would be that as a small business owner, this tax collection procedure would create competitive imbalances between marketers like us and refiners and this kind of imbalance would be very adverse to us.

Our national organization, Petroleum Marketers Association of America (PMAA) has developed a proposal which will still allow collection of the tax as gasoline breaks bulk at their terminal thus leading to no lag time in the collection process over that provided under the new law.

I respectfully request your support in this legislation.

MAKE IT A GREAT DAY!

Russ

R. H. Buchanan
President, CEO

DICKERSON PETROLEUM, INC.
202 WEST ADAMS ST. – PHONE 233-4120
BELLEVILLE, ILLINOIS 62221

June 26, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, D. C., 20515

Dear Sir:

We are writing you for help in revising the hastily drafted bill Section 1703 of the Tax Reform Act of 1986.

Our Company would suffer a loss of cash flow estimated at $232,225 which would transfer from our Bank to our refiner suppliers. We now are competing with integrated oil companies that have profits on production, refining and transportation. This would only increase their advantage to sell at their unit salaried stations below our cost.

Our sales for 1986 were $24,800,000 with a net profit of $213,000 which is less than one percent profit. We cannot stand additional advantages from refiner marketers. Please give this matter your attention.

Very truly yours,

DICKERSON PETROLEUM, INC.

Tom L. Dickerson
President

union

ECHOLS OIL COMPANY, INC.
BOX 1477 • GREENVILLE, S. C. 29602 • PHONE (803) 233-6205

July 2, 1987

The Honorable Dan Rostenkowski
Charman, Committee on Ways and Means
U. S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

I submit this letter in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of thoes eligible to collect and remit the excise tax on gasoline.

I am a small gasoline wholesaler in Greenville, S.C. My company was founded in 1932 by my father, and we have been a respected business in our community for 55 years.

I followed with great interest, your tough struggle with the Tax Reform Act of 1986. I felt that overall the act was fair. Everyone did not like it, but it was fair. I am sure this was one of your major concerns.

But, the elimitation of me and my company from collecting and submitting the federal gasoline tax if not fair for the following reasons:
1.Small wholesalers as myself will suffer a severe loss of cash flow and allow this cash flow to be transfered to my suppliers and other refiners who in many cases are in competition with me.
2. Many of my long time customers (churches, Transit Authorities,municipalities) are excempt from the Federal taxes. Now they will want to find another supplier so that they do not have to file for a refund. They will then become customers of the major oil companys.
3. As you know, in handling gasoline there are shortages and evaporation. Under the new law, I will have to pay the $.09 per gallon on all of my shortages.

I respectfully request your consideration of the proposal submitted by our national association the Petroleum Marketers Association of America which amends Section 1703 so that marketers would retain the right to remit the tax to the Treasury.

Thank You

Sincerely yours,

Laymon L Echols
Laymon L. Echols

First National Bank
You can depend on us...
JASPER, ALABAMA 35501

JACK G. ALLEN
VICE PRESIDENT

TELEPHONE
(205) 221-3121

July 28, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Re: Federal Gasoline Excise Tax Collection Procedure

Dear Representative Rostenkowski:

It is our understanding that Congress is considering certain technical corrections to be made to last year's Tax Reform Bill (H.R. 2636/S.1350). We would like to express our deep concern for one of the provisions of this Technical Corrections Bill.

A part of this bill indicates that the Federal Excise Tax will be collected by the refiner rather than the jobber at the local level. It appears that by doing this, the Federal Government may benefit from a one-time speed up of collections. However, it could be a crisis for local jobbers.

As the largest bank in Walker County, we are proud to say that all of the jobbers bank with First National Bank of Jasper, as far as we know. All of these jobbers are good customers of the Bank and, also, pay their taxes on time. However, they have come to depend on the fourteen day float which they have been allowed for the collection of this tax. Without this, it puts them at a distinct disadvantage in the marketplace to the oil companies.

We would appreciate your help and consideration in this bill.

Sincerely,

Jack G. Allen

A Wholly Owned Subsidiary of Moto, Inc.

FKG
OIL COMPANY

July 3, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing in reference to the change in the method of collection of federal excise tax which will be effective on January 1, 1988, if action is not taken.

The upstream collection of such taxes will impose an extreme hardship upon petroleum marketers, such as our Company. Not only will our cash flow be impaired, in normal operations, but we will also be less able to compete against larger companies.

Should congress be unwilling to change its new policy, it is my belief that many states will enact similar measures. Such a domino effect would surely all but eliminate smaller marketers, such as ourselves.

If the present collection procedures are ineffective, by all means make a reasonable change. Let it be done in such a way as to maintain competition. Don't kill flies with shotguns.

I ask that through the Technical Corrections Bill of 1987, you use your best influence to adjust this collection procedure.

Very truly yours,

Mike Lowry

Mike Lowry
Treasurer

721 West Main Street P.O. Box 122 Belleville, Illinois 62222 **(618) 233-6754**

AMOCO
AMOCO OIL COMPANY PRODUCTS

Fort Sumter Petroleum Company

Telephone (803) 534-5116
U. S. Highway 301 North, P. O. Box 423, Orangeburg, S. C. 29115

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515
Dear Sir:

I am writing this letter in response to Section 1703 of the Tax Reform Act of 1986 which, if enacted, could cause financial chaos to small distributors like myself and hundreds of others that submit the federal gasoline taxes twice each month.

As you know, the price of gasoline has increased by four times in the past ten years and our supplier's credit limit extended to us is directly related to our assets. A great portion of our assets in gasoline marketing is land and improvements which have not increased in value commiserate with the increase in cost of gasoline; therefore causing our credit limits to decrease. This has created a cash flow problem over the past few years and certainly the enactment of the current act would magnify this situation.

The following figures are furnished for your review for the tax that was submitted by our company for May 1987:

5/29/87 - Paid federal gasoline tax (.091¢/gal.) in the amount of $14,578.67. This was for gasoline sold at retail 5/1/87 - 5/15/87.

6/14/87 - Paid federal gasoline tax (.091¢/gal.) in the amount of $17,978.14.

6/19/87 - Paid state gasoline tax (.13¢/gal.) in the amount of $43,483.93.

The above figures should be evidence enough to see what a financial crisis will occur from a cash flow position if this act is enacted on January 1, 1988 or any future date. Not only will it be devastation to many jobbers but shall enrich the coffers of the refiner/supplier by millions of dollars. I would ask that you thoroughly scrutinize this Tax Reform Act and amend it so that we can continue to remit our taxes directly to the Federal Treasury.

Yours truly,

FT. SUMTER PETROLEUM CO., INC.

L. M. Bradshaw
President

FRANCOIS OIL COMPANY

128 West Main Street
Belleville, Wisconsin 53508
Phones
424-3303 • 424-3375 • 257-3304

July 6, 1987

Dan Rostenkowski
Chairman, Committee on Ways & Means
U.S. House of Representatives
Washington, D.C., 20515

Dear Representative Rostenkowski:

Re:Technical Corrections Bill - Section 1703

I would like to urge you to reconsider section 1703 of the Technical Corrections Bill. The effects of paying gasoline taxes on the gallons purchased rather than the gallons sold, would be absolutely devastating to local economies. It's hard to comprehend how elected officials could even have considered a bill that would so adversely effect the economy of their home state.

PLEASE give this matter your utmost concern and help local economies instead of lining federal pockets as planned.

Sincerely,

Richard C. Francois

Richard C. Francois

June 29, 1987

The Honorable Dan Rostenkowski, Chairman, Ways and Means
United States House of Representatives
Longworth House Office 1102
Washington, D.C. 20510

Dear Representative Rostenkowski:

As the chief financial officer of a petroleum jobbership in central Indiana, I am writing to urge your support in changing section 1703 of this technical corrections bill to allow marketers like ourselves to continue to collect and remit the federal excise taxes on diesel and gasoline products.

As a collection agent for the Treasury, we have been remitting monies for gasoline and diesel products now for 15 years. At a time when financing is critical to small businesses, please consider the impact on banking relations and outright additional interest expense to a company our size that employs 150 individuals.

In effect, you would transfer nearly $200,000 from us to our competition (Major Oil Refiners) to help them further eliminate needed competition in retail gasoline and diesel pricing.

At many times during the year the local retail selling prices of some products are below the costs of the same products from our suppliers. These suppliers (refiners) also market at retail.

These may sound like the woes of any small business but few industries are faced with the variety of capital intense demands like:

1. Complying with EPA underground tank replacement regulations
2. Absorbing the Superfund costs
3. Obtaining bonding and insurance coverage
4. Upgrading existing locations to meet competition
5. State revenue departments requiring Electronic Fund transfers
6. The administrative burden of excise, payroll, sales and personnel reporting
7. Suppliers cutting credit terms from 10 to 7 days and in some cases requiring Electronic Fund payments upon receipt of product

The backbone of commercial, farm, and strategic defense petroleum distribution is in the hands of many of our small jobberships. Refiners do not cater to this wholesale trade, therefore, not only retail but wholesale competition is effected by these measures being proposed.

Consider carefully the national statistics regarding the loss of nearly 38,000 retail stations since 1980. This attrition rate will no doubt be accelerated as small jobberships continue to be eliminated and as competition is replaced with handfulls of crude oil subsidized refiners.

These are real and immediate concerns to me as a small business owner, but more importantly as a member of the consuming public that looks to our elected officials to maintain a fair competative marketplace.

Sincerely,

Dale Flannery

Dale A. Flannery
Co-Owner, Secretary/Treasurer
G & G Oil Company
MUNCIE, IND.

GOA
GEORGIA
OILMEN'S
ASSOCIATION

404-938-0775
3581 Habersham at Northlake
Tucker, Georgia 30084

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Rostenkowski:

The Georgia Oilmen's Association is a trade association representing over three hundred (300) small, independent petroleum marketers which distribute over 50% of the petroleum products sold in Georgia. These marketers are small, independent business men and women who perform a vital role in the marketing of petroleum products. Our members not only retail, and or wholesale, petroleum products to the public, but also to schools, churches, small industries and farmers.

My purpose in writing is to respectfully request your consideration in changing Section 1703 of the 1986 Tax Reform Act. Provisions of this Act mandate that small, independent petroleum marketers pay their supplier the federal excise tax at the time of purchase. This requirement will create a tremendous cash flow problem as well as create a competitive imbalance between the marketer and his supplier as many suppliers compete directly with their branded marketers. I think that you will agree that it is extremely difficult to compete in the marketplace with the persons supplying you the product to be sold without further advantages such as the one that will be created if Congress does not agree to address this matter.

It is for the above stated reasons that I humbly request your consideration in allowing small, independent petroleum marketers to continue to remit the federal excise tax as presently permitted.

With best wishes and warm regards, I am

Sincerely,

Roger

Roger T. Lane
President

GERSTNER OIL COMPANY
RUDY GERSTNER
BOX 59
YANKTON, SOUTH DAKOTA 57078

June 26, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Dan Rostenkowski:

The newly enacted tax reform bill contains a provision which changes the gasoline excise tax collection procedure, so as to drastically impact my level of the petroleum industry distribution, both financially and competitively. I am very hopeful that you might be able to do something to rectify the situation before the effective date of January 1, 1988.

Present procedure has the gasoline distributors purchasing gasoline from the refiner without any excise tax included. The distributor in turn sells to dealers or consumers with the tax included in the selling price. The distributor then submits the tax collected to the Internal Revenue Service on a semi-monthly basis. The excise tax on a gallon of gasoline is nine cents by the way.

The new procedure will have the distributor paying the tax directly to the refiner upon thepurchase of a load of gasoline. This will be very favorable to the refiner and very unfavorable to the distributor. I know you voted against the tax reform bill because it was not fair to South Dakotans in several ways. This part is not fair to petroleum distributors.

Favoritism to refiners and importers in the new procedures results in at least two areas. First, this change gives them a competitive adavantage over distributors and dealers. For example, under this change a distributor who pulls product from a terminal on September 16 must pay for that product and the taxes; under historic industry credit terms, by September 26. The refiner does not have to pay those taxes to the govermnent until October 9. Moreover, a refiner who ships a load of product from its terminal to one of its own stations on September 16 also does not pay those taxes until October 9th. This provides refiners the use of excise tax money collected from distributors for up to 13 days and the use of their own excise tax dollars for up to 23 days. This is a substantial advantage for refiners.

The second grave inequity will be the drastic negative cash flow impact that I will witness while the refiner will enjoy a very positive eash flow advantage. We have been operating for many years with the 23 days of excise tax revenue mentioned in the example above as part of our normal cash flow. Suddenly on January 1, 1988 we will be required to pay that money to the Internal Revenue Service in one large lump sum. Needless to say this will be extremely difficult to do. The refiner will gain that same cash flow from the many distributors from that point on. The bigger the refiner, the bigger the cash flow gain.

I propose two possible solutions. The best one would be to continue to allow the distributors to collect and submit the excise tax on a semi-monthly basis in the same manner as the state of South Dakota collects their motor fuel tax. That being from distributors purchases rather than sales. Every purchase is documented by a bill of lading being sent to the state by the terminal from which product is lifted. The state has a copy of every gallon purchased and can audit the returns without leaving their office. This would require very little change from the present system and it would be equitable.

My second proposal would be to implement the new procedure as enacted except to allow the distributor to utilize the same timing on the submittal of the excise taxes to the refiner as the refiner witnesses in their paying of the taxes to the Internal Revenue Service.

Another item that negatively impacts all of us in the motor fuel business is the fact that no consideration has been given to evaporation and spillage. The most perfect operation cannot avoid some evaporation and spillage as well as bad debts. The new system makes no allowance for such. Consequently, we will be paying taxes on gallons we will never be able to sell and collect the taxes that have been paid on those gallons.

As you can see, I will be unfairly treated by this action. I would be happy to talk with you further if you would allow me the time. Please contact me (605 665 1112) if you have interest in my dilemma. I will greatly appreciate any help you can give my industry.

Sincerely,

Rudy Gerstner

Rudy Gerstner

GULF COAST
PETROLEUM, INC.
2406 HARPER ST. • P.O. BOX 43250 • JACKSONVILLE, FL 32203 • (904) 356-5515

August 3, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
Washington, DC 20515

Re: Gasoline Excise Tax
Technical Corrections Bill
Section 1703 of the Tax Reform Act of 1986

Dear Mr. Rostenkowski:

We are a large jobber and retailer selling nearly 60 million gallons of gasoline each year. Under the Tax Reform Act of 1986, we are scheduled to lose our right to collect gasoline excise taxes on January 1, 1988. This will cost us more than $1,000,000 permanently in cash flow and create an unfair competitive advantage for refiners and terminal operators who compete against us. We and others can ill afford such a dramatic change in the gasoline market.

Accordingly, we urge your support of the Technical Corrections Bill to permit collection of gasoline excise tax by jobbers and retailers.

Very truly yours,

James D. Francis
Chairman

Identical letters were received from the following:

Gulf Coast Petroleum, Inc.:
Randall A. Jones, President
Rosemary A. Jenkins, Controller

Baron Oil Company:
Arthur L. Cahoon, Chief Financial Officer
James D. Francis, Chairman

PetroMart Inc.:
James D. Francis, Chairman
Arthur L. Cahoon, Chief Financial Officer

Ray Distributing Co.:
Rosemary A. Jenkins, Controller
Randall A. Jones, President

SUN
GUY WILLIAMS & SON INC.
GOODYEAR
Goodyear Tires • Delco Batteries • Sunoco Fuels
326R East Dixie Avenue
Post Office Box 603
Elizabethtown, KY 42701-0603
502-765-2127

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Sir:

As you are aware, January 1, 1988, all petroleum marketers will loose the right to collect federal excise tax on gasoline. I think that petroleum marketers should be allowed to collect the taxes as in the past. It is urgent that in the Technical Corrections Bill there be a change to allow us to continue to collect and remit the tax. If our suppliers, that compete with us are allowed to do this, it increases the suppliers cash flow and decreases ours and puts us in a non-competetive situation. Also on business to governmental agencies, we must wait forty-five (45) days to recoup our federal excise tax from our suppliers, which means we operate on these sales in the red until we get our refund. This gives our suppliers a competetive edge in the market place on a direct marketing basis. This will be a detriment to all marketers and puts all small distributors in a very unprofitable situation, which we will not be able to control. It will mean that eventually all jobbers, especially small jobbers like me, will be eliminated from selling the government agencies that do not pay federal tax.

I am sure that you are aware that the profit on gasoline is just pennies, one to four cents, per gallon and when you give my suppliers a competetive edge such as this, it will drastically reduce the profit we make and tend to force small petroleum marketers out of business.

As an alternative to help prevent this, you could require that all taxes be paid on gasoline that is purchased in a month rather than on the gallons sold for that month. Petroleum Marketers Association of America has proposed such a change. This would be better than paying the federal excise tax to the supplier.

I would appreciate your serious consideration to the impact that you will have on all small petroleum businessmen throughout the United States and would hope that you would support some type of change to this Technical Corrections Bill. If you feel that to leave the tax collected as it is will result in fraud, please support my alternate bill that would only require us to pay on gasoline purchased through the month rather than on gasoline sold.

With kindest regards, I remain,

Respectfully yours,

Guy W. Williams Jr.

Guy W. Williams, Jr.
President

HDC HANDLEY DISTRIBUTING CO. UNION
UNION OIL PRODUCTS / P. O. BOX 107 / ROANOKE, AL. 36274 / (205) 863-2219

July 2, 1987

The Honorable Dan Rostenkewski
Chairman, Ways and Means Committee
House of Representatives
Washington, DC 20515
Dear Mr. Rostenkowshi:

I am a small Unocal jobber serving rural Randolph County, Alabama, and I wish to ask for your support on a matter of great importance to my company.

As you know, Section 1703 of the 1986 Tax Reform Act which is scheduled to take effect on January 1, 1988, would shift the right to collect and remit federal excise tax on gasoline from us (the marketer) to the refiners (Unocal) and terminal operators.

As a marketer I must protest this change. This would seriously affect the cash flow I need to run my business. I promptly file and pay excise taxes by the 9th and 24th days of each month. Because some New York dealers have been dishonest about paying their taxes, small, conscientious businesses all over our country will be punished. This seems unfair.

Terminal operators have our exact gallonage in their computers. We pay state taxes from these same records and are checked regularly by the state. It would be impossible to cheat - if, indeed, we would ever consider it.

Please support our position to amend Section 1703 of the Tax Reform Act. Small business needs your help.

Very truly yours,
Elissa V. Handley
Elissa V. Handley
Vice-President

Harper

Harper Oil Co.

Pierce Oil and Refining Company

June 24, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Mr. Rostenkowski:

This letter is in response to your request for comments on the Technical Corrections Bill (H.R.2636 and S.1350). Section 1703 of the Tax Reform Act of 1986 will seriously impair independent gasoline marketers like Harper Oil Co. by creating a competitive inbalance in the marketplace. Under this provision, as a marketer we must prepay the federal tax to our suppliers, who in actual fact are also our competitors. This will cause a loss of cash flow for all independent marketers while enhancing that of our supplier competition.

The National Trade Association of Petroleum Marketers, PMAA, has developed a proposal that would help to minimize the competitive inbalances created by Section 1703. We ask for your support of this proposal.

Sincerely,

Vincent O'Grady

Vincent O'Grady
Vice-President of Operations
HARPER OIL CO.

P.O. Box 3084 • 1023 E. Washington • Springfield, Illinois 62708 • 217/528-4088

Harper

Harper Oil Co.

Pierce Oil and Refining Company

June 24, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

RE: Technical Corrections Bill (HR 2636 & S 1350)

Dear Mr. Rostenkowski:

We feel that Section 1703 of this bill as it is now written will negatively impact the level of competitiveness among independent gasoline marketers like Harper Oil Co.

The prepaying of taxes to our suppliers (who are also competitors) could magnify any cash flow problems an independent company was having while tending to diminish any problems of that sort for competing suppliers.

The National Trade Association of Petroleum Marketers, PMAA, has developed some changes to Section 1703 which we feel would be beneficial to our industry. These changes are also endorsed by the Illinois Petroleum Marketers Association, IPMA.

We ask for your support of this amendment to H.R.2636 and S.1350.

Sincerely,

Albert C. Woodruff
Albert C. Woodruff
Office Manager
HARPER OIL CO.

P.O. Box 3084 • 1023 E. Washington • Springfield, Illinois 62708 • 217/528-4088

HARRIMAN OIL COMPANY, INC.
P. O. BOX 262
HARRIMAN, TENNESSEE 37748
(615) 882-8541

July 6, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D.C. 20515

Honorable Rostenkowski,

Harriman Oil Company, Inc., has been a marketer of gasoline fuel since 1933. We are extremely concerned about the proposed amendment to Section 1703 of the Tax Reform Act to shift the right to collect and remit the federal gasoline excise tax from marketers to refiners and terminal operators.

We support any steps that would effectively end excise tax evasion, but believe evasion can be eliminated without the proposed legislation that would affect small marketers such as ourselves.

The adverse effects of this proposed legislation to us are:

(1) The up-front payment of the excise tax before collection resulting in serious cash flow problems, and

(2) The lowering of our inventory quantities because of cash flow problems (This would be of a negative impact on the nation's secondary storage of gasoline)

(3) Regional refiners who operate retail service stations in close proximity to their refineries will have a clear competitive advantage because they will be able to collect the tax from their customers before it is due. This competitive advantage will have ripple effects throughout all surrounding markets

Our national organization, Petroleum Markters Association of America (PMAA) has developed a proposal which will still allow collection of the excise tax as gasoline breaks bulk at their terminal thus leading to no lag time in the collection process over that provided under the new law.

We urge your consent to the PMAA proposal. Thank you.

Sincerely yours,

Steve H. Kirkham, President
Harriman Oil Company, Inc.,

UNOCAL® UNOCAL®

HARTLEY OIL CO.
P.O. Box 10 907 Columbus Avenue
WASHINGTON C.H., OHIO 43160
Phone (614) 335-0690

P.O. Box 705 840 S. High Street
HILLSBORO, OHIO 45133
Phone (513) 393-5797

P.O. Box 228 133 Hawley Avenue
WILMINGTON, OHIO 45177
Phone (513) 382-2253

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington D. C. 20515

Dear Congressman Rostenkowski,

We would like to request that you take another look at Section 1703 of the Tax Reform Act of 1986 with special attention to the following:

a. Section 1703 was drafted hurriedly without note being taken of the imbalance of competition that it creates.
b. Suppliers do not suffer the loss of cash flow that marketers do. Since suppliers are in direct competition with marketers this gives unfair advantage to the suppliers.
c. A revision of Section 1703 is necessary if these imbalances are to be corrected.
d. A proposal has been developed by the Petroleum Marketer's Association of America that will settle the competitive problems caused by Section 1703 with the least possible dollar impact. At the same time this plan largely preserves the protections against tax evasion that were provided for in this part of the tax bill.

As you weigh the options that are available we think that serious consideration of the PMAA proposal would be a step in the right direction. In it's role as representative for marketers of our nation, this organization wants what is best for its members; but, also wants what will be an effective tool to collect taxes that are due the government on fuel purchases.

Thank you for your time.

Respectfully,

HARTLEY OIL COMPANY

Earl L Hartley

Earl L. Hartley, President

HEADLEE PETRO-MARK
HEADLEE Oil Co., INC.
106 S. 42nd Street • 405 / 237-5509 • P.O. Box 726 • Enid, Oklahoma 73702

June 26, 1987

The Honorable Dan Rostenkowski, Chairman
Committee of Ways and Means
U.S. HOUSE OF REPRESENTATIVES
Washington, D. C. 20515

Dear Mr. Rostenkowski:

We respectfully request a change in Section 1703 of the Techinal Corrections Bill, so we may continue to pay the gasoline excise tax on gallons purchased directly to the government. We have faithly collected and paid the federal excise tax on sales for several years. By changing this, so we would no longer be allowed to do this, we would be placed in a serious cash flow position, severly effecting our ability to do business. Certainly, there would be a competitive imbalance with those direct marketing their products (because of the connections with refinery operations.) Please do not make this imbalance in cash flow in favor of those who do not need an "improvement in position".

We have no objections to the switch from payment of collected taxes on sales to payment on purchases, although this will have some negative cash flow for us also. However, we are aware this change will allow the government to receive their money more quickly, and we accept this change as necessary under the government's current financial condition.

Please consider the small independent business men who make up the majority of petroleum marketers and distributors throughout the country, before you decide this very important issue.

Sincerely,
HEADLEE OIL CO., INC.

James H. Moore, Jr.
President

COMPLETE LINE OF PETROLEUM PRODUCTS - LPG

TEXACO CONOCO KOCH OXY CITIES SERVICE Chevron Purolator CITGO ARCO APCO

HEMPELS GAS & APPLIANCE
814 EAST THIRD
ALLIANCE, NE
69301

June 26, 1987

JUN 30 1987

The Honorable Dan Rostenkowski
Chairman,
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Sir:

I am writing to you regarding section 1703 of the Technical Corrections Bill. According to the provisions of this bill, I, as a marketer, would have to pay my Federal Excise Tax to the Refiner at the time of purchase. This would mean that I would not only have to come up with a lot more capital to cover this expense but that I would also have to pay tax on the evaporation and shrinkage involved in a bulk operation. Hence, additional expense out of my small pocket.

Another result of this provision would be that each and every school, government entity, or other Federally tax exempt organization would have to apply individually for excise tax refunds. We presently take care of this bookkeeping at no expense to the government. To handle the additional bookkeeping, will require another agency for the government.
Please give this your due consideration as us little people cannot continue to carry more and more of the tax burden for operating our country.

Sincerely,

Bruce Johnson

Chevron

Hildreth Oil Co.
Jobber, Chevron U.S.A. Inc. **Products**
P.O. Box 296, Bowling Green, KY 42101 • Phone: (502) 842-0361
2715 Clarksville Hwy., Nashville, TN 37208 • Phone: (615) 244-1880

July 1, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am deeply concerned about Section 1703 of the Tax Reform Bill because of the potentially devastating effect it would have on me as a small businessman.

While I support the premise that taxes be paid on gallons purchased rather than gallons sold as a method to eliminate tax fraud, I want to point out that forcing me to pay this tax at the time of purchase will create a tremendous financial hardship for me. It is imperative in order for me to survive that I be allowed to continue to collect and remit the tax. In my opinion, most businesses similar to my own could not raise the additional cash to pay the tax in advance.

In addition, by taking away our tax collection right and giving it to large suppliers, you are handing over the market place to a few large oil companies. The additional cash flow they would receive would be used to put small business in a most unfavorable competitive situation.

I urge you to support the Technical Correction to Section 1703 of the Tax Reform Act, and allow petroleum marketers to continue to collect and remit the federal excise tax on gasoline.

Sincerely,

C. Carroll Hildreth

C. Carroll Hildreth
President

HOLMES OIL COMPANY
1114 BUFFALO STREET
MANITOWOC, WI 54220
(414) 682-7782

July 2, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman,

I am writing to express my concerns about the effects of **SECTION 1703**, of the Tax Reform Act.

It is my understanding that this section will change the method of collecting Federal Motor Fuel taxes effective January 1, 1988.

The change that concerns me is that the refiners will collect the federal excise tax as part of the gasoline invoice.In the present method we pay into our local bank tax depository on the 14th and 29th of each month covering the purchases of the previous 15 day period.

The proposed change would make the small marketers subject to the whims, wishes and policies of their supplying companies. In addition to this situation, there is the concern about credit policies in which the supplier would be free to dictate their own terms rather than to follow the federal tax rules which would apply to them as they apply to all marketers now.

Section 1703 creates a severe competitive imbalance in the local market-place. In our small community, for instance, we have three retail gasoline outlets operated directly by refining companies. Under the new plan they would have between 14 and 29 days in which to remit the Federal Excise Tax while we as competitors would be subject to the supplier's credit terms, which at most would be 10 days and could convievably be C.O.D.

Section 1703 will also severely impact the credit terms alowed to farmers and small consumers. It is presently customary to allow farmers at least E.O.M terms. Even under the present Federal Tax payment rules system it is very difficult for us, as small martketers, to fund the customary terms. Section 1703 will rapidly escalate our payment of taxes and we will suffer severe cash flow problems that will greatly impact our demands for borrowed capital.

SECTION 1703 NEEDS TO BE REVISED IF THESE SERIOUS COMPETITIVE IMBALANCES ARE TO BE REMEDIED.

It is my understanding that this change came about because there were a few individuals in our industry who were deceptive and defrauded or avoided paying the Federal Gasoline Tax. I also understand that the rational now is that the proposed change will reduce the number of those paying the tax from 6000 to from 500 to 600.

This might appear to be a solution to the problem, however, the experience of the Energy Department during the allocations of 1973-1980 will verify that the 500-600 are virtually unauditable.Upon investigation, I think that you will find that almost every refiner was forced by the federal government to refund to their customers!

Most of these refunds were, in the final analysis, based on the negotiated settlements and not over-charges as charged by the Energy Dept. We have recently received a portion of the crude oil "stripper well" refunds and are waiting for the balance. In addition to this, we are still waiting to be allowed to apply for a refund that is being negotiated between our primary supplier and the D.O.E. The allocation of gasoline was discontinued in early Spring,1981!

After the experience that the D.O.E. has with the refineries, involving the Federal Gasoline Taxes, it appears to me that Section 1703 would have "the foxes guarding the chic ken coop"!

I am sure that investigation will show that the majority of "small marketers" are honest and responsible and therefore should not be penalized by this serious competitive imbalance for the actions of a few "bad actors".

The national trade association of the petroleum marketers, PMAA, has developed a proposal which should resolve the competitive problems created by Section 1703 with the least possible revenue impact. This proposal would, at the same time, preserve the protections against tax evasion as established in Section 1703.

I appreciate your attention to this serious matter. I would welcome the opportunity to talk to you about this if you have any questions.

Most sincerely,

William C Holmes

William C. Holmes, President

HOPSON OIL COMPANY, INC. 1205-25 WHITEROCK AVENUE P.O. BOX 832
PHONE 542-5343 WAUKESHA, WI 53187

July 3, 1987

The Honorable Dan Rostenkowski, Chariman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Re: Section 1703 Tax Reform Act 1986
HB 2636

Dear Sir:

We are writing to request that changes be made in section 1703 to allow marketers to continue to collect the federal excise tax. It is our belief that this section of the Tax Reform Act was drafted hastily and without full consideration of the over-all effect on marketers and local economies.

The loss of working capital is a major concern. On a monthly basis we pay in excess of $100,000.00 in federal taxes. We do this on a timely basis and deduction of that with each purchase would severly restrict our cash flow. This restriction will affect other local businesses, especially our bank. This also means a loss of working capital for them, which affects their ability to offer loans to the community. Because of the nature of our business, winter often brings cash flow concerns now. Having the tax collected from refiners would be a death blow to many of us.

Locally, some refiners and suppliers also market in our area. This would be a distinct advantage to their business while severely restricting ours. This would allow them a competitive advantage while using our money.

Each year it gets increasingly difficult for many small businesses, especially petroleum marketers, to stay in business. We seem to repeatedly be fighting the same battles and once again the majority are being threatened with punishment for the sins of a few. The burden for adequate implementation and policing of the present policy should not be borne by us.

Perhaps all of the questions have not been asked, nor all the solutions sought. It is our understanding that there is a compromise developed for your consideration. Please look at this further and allow us to continue to collect the federal excise tax.

Vote FOR small business.

Yours truly,

L. F. Nagel, President

Gasoline
Motor Oil
Heating Oil

HOWARD E. THOMAS, INC.

Tires
Batteries
Accessories

AMOCO

P. O. BOX 109
PHONE 549-5829
WALTERBORO, S. C. 29488

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

I submit this letter in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

The South Carolina Petroleum Marketers Association is a statewide trade association consisting of 250 independent small businessmen supplying petroleum products to the consuming public, to the residential fuel oil consumer, to commercial and industrial facilities, and other users of petroleum products. These member firms handle over 60% of the taxable gasoline and diesel fuel sold in the state and over 85% of the home heating fuel consumed in the state. Collectively, they collect and remit motor fuel excise taxes on 600,000,000 gallons of taxable fuel a year.

If no change is made in the implementation of the ruling in Section 1703 many of these distributors, or jobbers as they are often called, may be forced out of business. They will suffer a severe loss of cash flow. To increase their credit lines may be impossible.

Their suppliers, with whom they very often compete, will conversely reap the benefits of the distributors' loss leaving the small business jobber at a distinct competitive disadvantage.

If Congress does indeed increase the excise tax on gasoline as appears may be the case, the situation will be even further aggravated. If having to pay 9.1 cents at the terminal to the supplier might break the distributor, certainly 19.1 cents, or 39.1 cents per gallon will.

Additionally, if the federal government insists on requiring payment "up front," the likelihood of the state following is enhanced. With South Carolina at 15 cents per gallon tax, the distributor is looking at at least 24.1 cents per gallon prepayment of taxes, and a possibility of 34.1 cents or even 54.1 cents per gallon.

These figures, without question would destroy the distributor network of petroleum products, not only in South Carolina, but in the nation. And, this distributor network which has provided a vital service to the American consumer for more than half a century.

Thank you.

Sincerely yours,

Howard E. Thomas
Howard E. Thomas

INDEPENDENT OIL CO., INC.

PETROLEUM DISTRIBUTORS SINCE 1937

P. O. BOX 1142 PHONE AREA CODE ~~309 794-9399~~
ROCK ISLAND, ILLINOIS 61201

July 8, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

The Tax Reform Act of 1986 has stripped our right to remit the federal excise tax directly to the government via bank deposits. Please reconsider and allow us to remit on a timely basis instead of at the terminal gate.

If you don't react and change, it will be devastating to marketers. 1981 brought decontrol to our industry and 30% of the weaker marketers went out of business. In the past 18 months major oil companies have shortened our payment terms. The average invoice was due in 12 days. Now, the average is 9. This cost us $120,000 in cash flow.

If the present tax reform act is allowed to stand 30% of the marketers will be forced out of business. The average marketer is not financially strong enough to bear the extra burden.

Please help! Thank you.

Larry E. Darnell

Larry E. Darnell
President

**Independent
Oil Mens' Association
of New England**
78 Northeastern Blvd. Nashua, N.H. 03062
603/883-7963

July 6, 1987

The Honorable Dan Rostenkowski
Chairman - Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

In your review of changes to the 1986 Tax Reform Act our members would strongly urge that you address Section 1703 which involves the gasoline excise tax collection procedure.

The small, family owned, independent petroleum marketers in New England support the recommended changes proposed by the Petroleum Marketers Association of America.

Section 1703 as currently written would position these marketers at a distinct competitive disadvantage. The cash flow of these businessmen would be severely hampered and thus, continue to foster the imbalance that is inherent between the independent marketer and his supplier.

Our members do not condone the actions of those wholesalers who attempt to avoid their tax responsibility. However, the corrective action taken in the Tax Reform Act, which changes the tax collection procedure method, serves only to create more hardship to the vast majority of independent marketers who are operating within the established laws.

Your support of the Petroleum Marketers Association of America's position on this issue would ensure the viability of the small independent petroleum marketer in New England.

Sincerely,

William R. Fortey
President

INDIANA OIL MARKETERS ASSOCIATION, INC.

8780 Purdue Road • Indianapolis, Indiana 46268 • (317) 875-9057

June 30, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

Re: Section 1703 of the 1986 Tax Reform Act

As you know, Section 1703 is scheduled to take effect January 1, 1988. This would shift the right to collect and remit the federal gasoline excise tax from marketers to refiners and terminal operators.

As small businessmen, we are seeking your support to amend Section 1703 so that marketers would retain the right to remit tax to the Treasury. It is likely this issue will be considered when Congress acts on the technical corrections bill (H.R.2636/S.1350), a bill which makes mostly technical corrections to last year's tax reform bill. It is our understanding this is an appropriate legislative vehicle for the kind of change we are requesting.

We certainly support steps to end excise tax evasion but believe evasion can be eliminated without adversely impacting the thousands of legitimate marketers who have remitted excise taxes to the Federal government for the last thirty years.

Enactment of Section 1703 not only will deal a devastating cash flow impact to the marketer, but will create a further competitive imbalance between the marketer and his refiner-supplier. In other words, the marketer's cash flow will be transferred to his supplier who already in many cases is his biggest street competitor; and, who already has the "deepest pockets."

Our national organization, Petroleum Marketers Association of America (PMAA), headquartered in Washington, has developed a proposal which will still allow collection of the excise tax as gasoline breaks bulk at the terminal thus leading to no lag time in the collection process over that provided by the new law. Would you please work with them.

Thanks for your consideration.

Very truly yours,

Jack Stough

L. Jack Stough
Executive Director

J&L OIL, INC

The Very Best
204 Route 45
Vernon Hills, IL 60061
Telephone (312) 367-3600

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Re: Technical Corrections Bill H.R. 2636

Dear Representative Rostenkowski:

We would like to urge you to favorably consider the proposal of Petroleum Marketers Association of America (PMAA) that addresses the competitive problems created by Section 1703 with minimal revenue impact while preserving the protections against tax evasion established in Section 1703.

We feel that the haste with which Section 1703 was drafted did not allow adequate study of the competitive imbalances it creates. We will suffer a loss of cash flow while our suppliers, with whom we compete, will not, leaving us at a competitive disadvantage. Section 1703 needs to be revised to remedy the competitive imbalances it creates.

Thank you for considering my views.

Sincerely,

J. & L. OIL, INC.

G. L. Wright
President

Jahraus Oil

Phone (618) 245-3591

P. O. Box 190
Farina, Illinois 62838

July 10, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Congressman Rostenkowski:

I am writing to you about the Tax Reform Act of 1986 in regards to the collection of federal excise tax. As the bill is written, as of January 1, 1988 our company would have to prepay our excise tax to the refinery where we purchase our fuel. As a small businessman, I am totally against companies like mine losing their rights to collect federal tax. If we lose our right to collect this tax, I can see that this would greatly hinder the growth and profitability of our business. Our cash flow would be reduced and if the federal tax were increased in future years, our ability to spend money and prosper would be greatly affected.

I urge you to back a change in this bill and let small businesses like ourselves keep collecting this tax. Thank you.

Sincerely,

Kevin D. Jahraus
Manager

CHEVRON
BRANDED
JOBBER

JOHNSON PETROLEUM MARKETING, INC.
P.O. BOX 1237
207 NORTH BRETT
CRESTVIEW, FLORIDA 32536
(904) 682-2127

W.E. (Bill) JOHNSON
President

July 26, 1987

Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Sir:

The Tax Reform Act of 1986 changed dramatically the gasoline excise tax collection procedure. Under Section 1703 of the Act, effective January 1, 1988, the point of taxation is to be at the terminal rack where trucks are first loaded for further distribution. Independent petroleum marketers, many of whom have paid the excise tax, based on sales of product, directly to the federal government for almost 30 years, must now pay the 9.1 centers per gallon federal tax directly to the refiner or terminal operator as part of the price of the product. In addition, Section 1703 provides there will be no tax exempt sales of gasoline after the product leaves the terminal. Current tax exempt purchasers such as school districts, state and local governments, etc. must, under the new law, pay the tax and apply for a subsequent refund. There are two prime reasons for this change. The first was revenue enhancement. The Department of the Treasury estimates this new provision will increase revenues by approximately one billion dollars over four years. most of which is the result of accelerated payments of the tax collections. The second reason for the change was a belief by Treasury that by reducing the number of remittors and by allowing no tax exempt sales downstream that the incidence of excise tax evasion would be reduced substantially.

The Petroleum Marketers Association of Americe, the Florida Petroleum Marketers Association and I support efforts to halt excise tax evasion and we believe such evasion can be halted without jeopardizing the cash flow position and the credit lines of Independent marketers or without placing these marketers at a competitive disadvantage vis-a-vis their refiner/suppliers. We believe Section 1703 can be modified slightly and still achieve the twin objectives of generating revenue and reducing the incidence of evasion.

Specifically, we propose one significant change in Section 1703. This change would allow qualified wholesalers to remit the tax directly to the Treasury on their purchases at the terminal rack under the same term and conditions as applicable to refiners and terminal operators. As under Section 1703, there would be no tax exempt sales downstream thus eliminating the daisey chain operations which made evasion so easy in the past. Qualified wholesalers would have to meet financial responsibility requirements to be established by the Treasury, provided, however, such standards were set commensurate with the marketer's tax exposure and not used to effectively eliminate independent marketers from the remittance process. This financial responsibility requirement would provide measurable assurance that the Treasury would in fact receive the money.

There are numerous arguments to justify this approach. First, it removes the competitive advantage which Section 1703 gives refiners and terminal operators over independent marketers. Second, it aids greatly marketers cash flow at a time when marketers need cash desperately to comply with other government regulations. Third, it is revenue neutral. The Treasury collects its money in the same time frame as under Section 1703. Fourth, and most important, it provides a solid audit trail for the IRS. The IRS can merely match marketer purchases against refiner and terminal operator sales.

For all of these reasons I urge you to support these proposed changes as ammendments to the Technical Corrections bill (HR 2636/S1350).

Sincerely,

William E. Johnson

William E. Johnson

Joseph Mahony and Company

Accountants For:
Service Stations & Petroleum Jobbers

209 Muller Road
P.O. Box 298
Washington, Illinois 61571
Phone 309-444-8556

July 6, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman Rostenkowski:

My firm prepares the Federal Motor Fuel Tax returns for many of our clients who sell gasoline and diesel fuel.

The regulations scheduled to become effective January 1, 1988, whereby those distributors would be required to pay the FMFT on gasoline to a refinery would have serious adverse results.

Our clients cash flow would be critically impaired and certain costs including interest, record keeping, and accounting fees would increase. Their suppliers (who are often their competitors) would gain increased working capital and further enhance their competitive advantages.

In its present form, the proposed regulations would be effective in reducing FMFT tax avoidance. The price for that reduction would be quite high as the businesses most affected would be honest small and medium sized petroleum distributors whose profits would be reduced or eliminated. Most tax evasion of the gasoline FMFT could be simply eliminated if no distributor was allowed to sell to another distributor on a tax free basis.

The scheduled regulations would create problems involving the tax on gasoline that is purchased tax paid at 9.1 cents per gallon which is later blended to produce gasahol that is taxed at 3.1 cents per gallon.

Another problem would be the FMFT on sales to state and local government units and other organizations which are exempt from FMFT. Would those purchasers be forced to buy direct from the major oil suppliers in order to retain their exemption or would they be required to file claims with the Treasury Department creating an enlarged bueraucracy?

The scheduled regulations, further, do nothing about FMFT cheating on diesel fuel which from my experience is far more widespread than the tax evasion on gasoline sales.

Very truly,

Joseph Mahony

Joseph Mahony

KENT
OIL, INC.
3314 W. LOOP 250 N.
P. O. BOX 908001
MIDLAND, TX 79708-8001 (915) 563-1620

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

Please let me again express my concern about the Tax Reform Act of 1986 which will change the collection of motor fuel excise tax from independent marketers to refiners. It is my understanding that the benefit of this change is to the Treasury Department by reducing the number of individuals involved in the tax collection process down to a few hundred refiners and terminal operators.

We sell approximately 12,000,000 gallons a year of petroleum products and this change will have a dramatic negative impact on my business. This change could literally be the financial ruin of many independent petroleum marketers around the country.

We currently remit federal excise taxes of approximately $45,000 twice a month. We also remit $120,000 each month in state gasoline taxes. I mention the state taxes only because I am aware that many states will be observing this change at the federal level and this could ultimately cause the states to change their collection method also.

This equates to a substantial increased cost of doing business. More specifically, losing the ability to remit federal excise taxes will cause us to pay them up front, costing us approximately $50,000 immediately, out of cash flow. If you add the impact of our state adopting the same proposal, then this could potentially cost us over $100,000 in initial cash flow. We would have to borrow this money as we do not have $100,000 excess cash.

This also adds the additional interest cost. Making this change at the federal level we estimate will cost us an additional $15,000 per year minimum by losing the approximate two week remittance time and the direct interest cost of borrowing the funds. In 1986, our company had a net loss of $9,000. This proposal alone would cause us to double that loss.

If the State of Texas adopts the federal proposal, then we estimate the cost to be closer to $30,000 in increased cost. As you know, Texas in general is hurting economically, but West Texas is in a near depression. The oil economy has devastated West Texas and losing only $9,000 last year was a remarkable achievement. Now I am not only faced with these economic problems, but I am facing a potential death blow to my cash flow as well as increased interest expense. What happens if the banks will not loan me this money?

I compete daily with the direct operated outlets of Exxon, Texaco, Chevron/Gulf, etc. For a small company we do a good job of holding our own. However, giving them the use of my federal taxes for two weeks is a competitive disaster. One thing Exxon does not need is my tax dollars or tax dollars of hundreds of other marketers to use for two weeks for their own benefit.

Our national organization Petroleum Marketers of America has developed a proposal which will still allow collection of the excise tax as gasoline breaks bulk at their terminal thus leading to no lag time in the collection process over that provided under the new law.

I urge you Representative Rostenkowski to support an amendment to change this. An amendment to the Technical Corrections Bill to leave the current system in place is necessary for the survival of many small businesses and the jobs they provide.

Sincerely,

William B. Kent
President

Knox Nelson Oil Co., Inc.

Mobil PHILLIPS 66 CITGO

101 Pennsylvania • Telephone (501) 534-4941
P.O. Box 5715
Pine Bluff, Arkansas 71611

July 2, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman,

I am a small Oil Jobber in Pine Bluff, Arkansas. I respectfully request your assistance in Modification of Section 1703 of 1986 Tax Law to allow me as an oil marketer the right to remit the excise tax on motor fuel directly to the U. S. Treasury.

As a small business, I am struggling to make a profit. The impact of this new law will further the competitive imbalance between me as a Small Business and the large oil companies. It will also cause a serious cash flow problem for me.

My company has never been late on remitting any tax in our thirty-five years of operation.

Sincerely,

Knox Nelson

Knox Nelson

"Quality Petroleum Products at Competitive Prices"

LESLIE F. RUSSELL OIL CO., INC.
P.O. BOX 5066 • PHONE 534-6621
PINE BLUFF, ARKANSAS 71611

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D.C. 20515

RE: Federal Excise Tax Collection
Procedure in 1986 Tax Reform
Act needs to be amended

Dear Congressman Rostenkowski,

We need your support. Please help us to make the changes necessary in the Tax Reform Act of 1986 to allow marketers to continue to collect the federal excise tax on gasoline after January 1, 1988.

The Tax Reform Act as it stands now will put a severe hardship on the small oil jobber due to increase in inventory cost and reduce cash flow. It is the small oil jobber which keeps the price of gasoline competative. Each one of us which is forced out of business by this law will make it that much easier for the large companies to raise prices of gasoline causing inflation to skyrocket.

It is likely that this issue will be considered when Congress acts on the technical corrections bill (H.R. 2636/S. 1350).

We urge you to help us make the necessary corrections so that we will be allowed to continue to collect the excise tax. By doing this you will be allowing small businesses to remain strong and keeping America's gasoline prices low.

Thank you in advance for your support.

Sincerely,

Jim Russell

Jim Russell
President

CONOCO
Hottest Brand Going
LITTLEFIELD OIL CO.
P. O. BOX 20
BOONEVILLE, AR 72927

July 3, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Dear Sir:

I am a Petroleum Marketer in the small town of Booneville, Arkansas, and there are many hundreds more like me throughout the country.

We would like to ask you to amend Section 1703 of the 1986 Tax Reform Act, so we may retain the right to remit the tax to the U. S. Treasury.

We are asking your help because I think it will put many Petroleum Marketers out of business if we have to pay the tax up front.

Thank you very much for your help and consideration.

Sincerely,

A. B. Littlefield, Partner
Littlefield Oil Company

Lyden
OIL COMPANY
AMOCO

July 1, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Congressman Rostenkowski:

Currently your committee has before you the Technical Correction Bill which is giving consideration to the gasoline excise tax collection. As a petroleum marketer for the past sixty-eight years, we have faithfully collected and remitted to the state and federal governments all taxes that have been collected and are due. We have been audited by federal auditors in a routine manner and have had very few exceptions.

I have felt that the controls in place, with proper monitoring, are more than ample to give the government that security necessary to collect the taxes. I feel that it is an imposition to those of us who have consistently tried to implement this process to ask us to prepay this tax before we collect it. We will be penalized for the lack of proper supervision and monitoring of the tax collection procedure and for the violations created by a few.

The Lyden Oil Company will suffer, effective January 1, 1988, the cash flow impact of approximately $650,000. This will necessitate our going to borrowed funds at an interest rate that will impact considerably on our profit structure. We work on less than one-half cent per gallon net profit. Every cost has to be justified. This is one cost I cannot justify, as I do not see any real advantage to the government other than the initial cash flow at its inception. It is not going to raise income one bit.

The State of Ohio supervises, along with the marketers, any irregularities in gasoline and diesel fuel tax collections. It has worked very well. The marketers themselves help police it by reporting irregularities. The State's method of checks and balances is most thorough. I cannot see why the federal government could not duplicate the same procedures.

In addition, possibly a token bond could be implemented that would require tax free purchasers to be registered, thus, placing the onerous on the purchaser. Those whose plan was to deceive would not register because a report had to be submitted monthly by both buyer and seller of tax free products.

I would hope that these suggestions would help in developing some type of relief for a large percent of small business people in the oil industry.

Sincerely,

W. G. Lyden, Jr.

L

LYKINS OIL CO., INC.
P.O. BOX G, 1366 ST. RT. 131, MILFORD, OHIO 45150 (513) 831-8820

June 28, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

I am an independent petroleum marketer in southwestern Ohio, and I am writing to you to please reconsider Section 1703 of the Tax Reform Act of 1986.

As of January 1, 1988, I will lose my right to pay my gasoline excise taxes to the government. As you well know, I will have to pay this amount up front to the refiner when I purchase the product. This would immediately increase substantially my cost of doing business, as well as tighten my credit lines with my bank and my supplier. This will cause a serious threat to my cash flow, and create a competitive imbalance within my business, as well as my fellow independent petroleum marketers.

In my business, I remit gasoline excise taxes to the government twice a month. My average payment is $185,635.80. I have done this faithfully, along with the many other petroleum jobbers across this nation, and now the government wants to return to the pre-1958 system of allowing only refiners and importers to collect the tax? Again, jobbers **suffer**, and the suppliers **benefit!** Thieves **win** and honest people **lose!** This is **not** the American Way!

As you know, the PMAA (Petroleum Marketers Association of America) has been lobbying strongly for the right to allow marketers to continue to pay the tax -- but on gallons purchased, rather than gallons sold. I fully support this right.

I urge you to take my views and thoughts into consideration, and think of the large and devestating impact that the small and honest independent petroleum marketers of this country will feel on January 1, 1988.

Thank you for your valuable time and consideration.

Truly Yours,

Donald F. Lykins
President
Lykins Oil Company, Inc.

martin & bayley
THE FOOD PEOPLE...
Box 385 Carmi, Illinois 62821
Phone (618) 382-2334

July 13, 1987

The Honorable Van Rostenkowski
Chairman
Committee of Ways and Means
2111 RHOB
Washington, DC 20515

Mr. Rostenkowski:

In reference to section 1703 of the Tax Reform Act of 1986 please note the following:

1.) Section 1703 does not realize the competitive imbalance it creates. If gasoline refiners can precollect any Federal excise taxes this will create a serious competitive advantage from them. How can independent marketers compete with a large refiner who has this type of positive cash flow.

2.) How will marketers adjust to the decreased working capital due to the accelerated payment of the tax. Will jobs be lost.

3.) Let the various State Department of Revenue aid in the auditing of the Federal excise tax. Our state does an excellent job in auditing state motor fuel taxes.

The National Trade Association representing petroleum marketers PMAA has developed a proposal that will resolve the competitive problems created by section 1703. Please consider this proposal seriously. We want to be able to compete fairly with the refiners, but not give them a distinct advantage over us.

Sincerely,

Mark Bayley,
Director of Petroleum

BIG JOHN'S
Super Food Stores
Convenience Store Distributors
EXCEL
Food Stores
HUCK'S
Convenience Food Stores

Matthews Brothers Wholesale, Inc.
P.O. BOX 1186
CLARKSBURG, W. VA. 26301
PHONE: (304) 624-7601

July 1, 1987

The Honorable Dan Rostenkowski
Chairman
Committe on Ways & Means
U. S. House of Representatives
Washington, DC 20515

Dear Congressman:

As a petroleum marketer and an independent businessman that will be directly affected by the implementation of Section 1703 of the Tax Reform Act of 1986, we urge you to consider the following:

> Section 1703 was drafted without an assessment of the competitive imbalances it creates.

Basically, a company like ours will suffer a loss of cash flow while our suppliers, with whom we compete, do not, leaving us at a competitive disadvantage.

Because of this, Section 1703 needs to be revised, in order to remove these competitive imbalances and provide for free and equal competition in the marketplace.

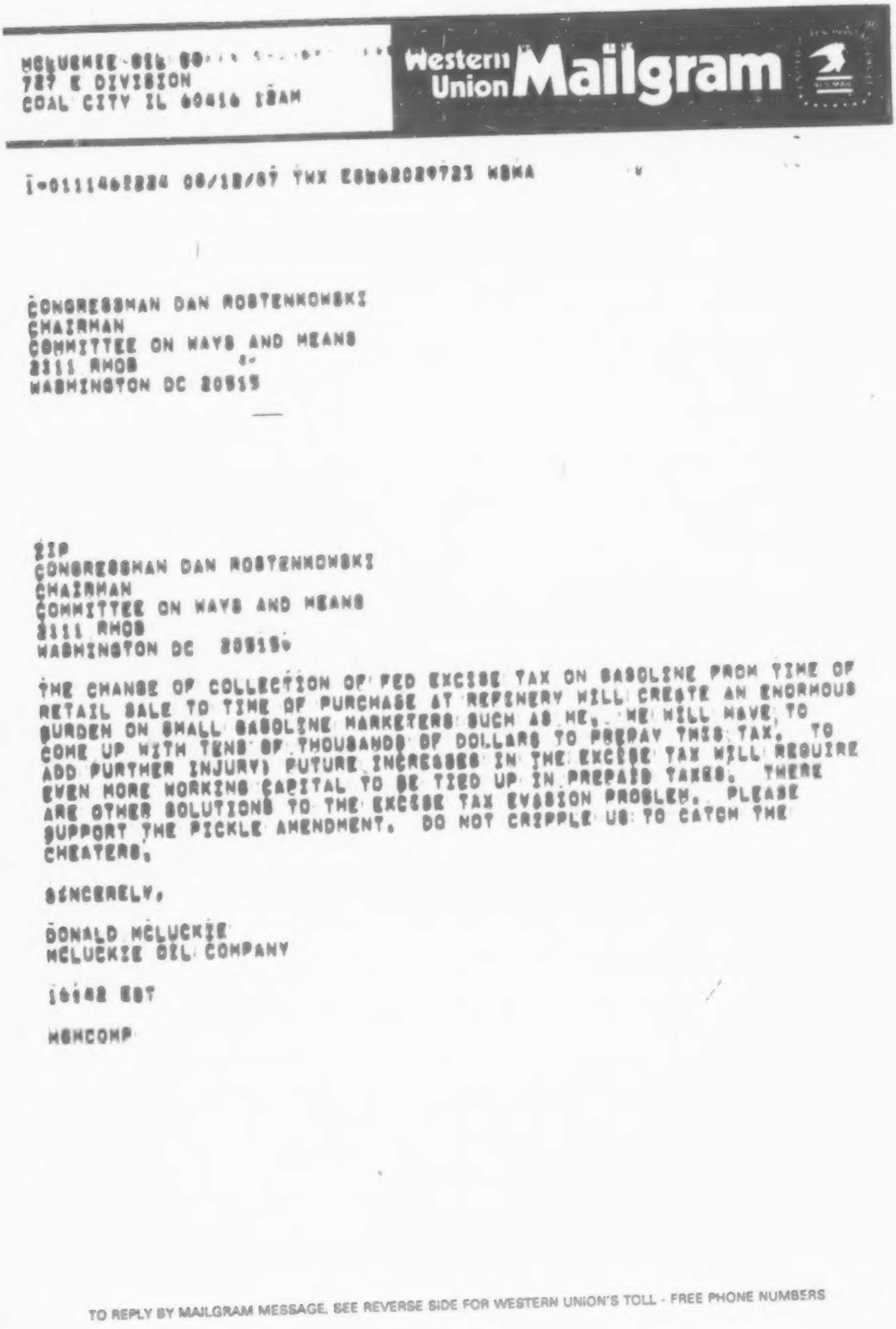
The Petroleum Marketers Association of America and other National Trade groups representing petroleum marketers have developed a proposal that will resolve this competitive problem, created by Section 1703 with the least possible revenue impact, while at the same time providing the necessary safeguard against tax evasion provided by the bill.

We urge you to consider this proposal. Thank you.

Sincerely,

MATTHEWS BROTHERS WHOLESALE, INC.

Nelson E. Matthews
President



Western Union Mailgram

MCLUCKIE OIL CO
727 E DIVISION
COAL CITY IL 60416 12AM

1-0111462224 08/12/87 TWX ESB62029723 MGMA

CONGRESSMAN DAN ROSTENKOWSKI
CHAIRMAN
COMMITTEE ON WAYS AND MEANS
2111 RHOB
WASHINGTON DC 20515

ZIP
CONGRESSMAN DAN ROSTENKOWSKI
CHAIRMAN
COMMITTEE ON WAYS AND MEANS
2111 RHOB
WASHINGTON DC 20515

THE CHANGE OF COLLECTION OF FED EXCISE TAX ON GASOLINE FROM TIME OF RETAIL SALE TO TIME OF PURCHASE AT REFINERY WILL CREATE AN ENORMOUS BURDEN ON SMALL GASOLINE MARKETERS SUCH AS ME. WE WILL HAVE TO COME UP WITH TENS OF THOUSANDS OF DOLLARS TO PREPAY THIS TAX. TO ADD FURTHER INJURY, FUTURE INCREASES IN THE EXCISE TAX WILL REQUIRE EVEN MORE WORKING CAPITAL TO BE TIED UP IN PREPAID TAXES. THERE ARE OTHER SOLUTIONS TO THE EXCISE TAX EVASION PROBLEM. PLEASE SUPPORT THE PICKLE AMENDMENT. DO NOT CRIPPLE US TO CATCH THE CHEATERS.

SINCERELY,

DONALD MCLUCKIE
MCLUCKIE OIL COMPANY

16:42 EST

MGMCOMP

TO REPLY BY MAILGRAM MESSAGE, SEE REVERSE SIDE FOR WESTERN UNION'S TOLL - FREE PHONE NUMBERS

JIFFY STOP™
MID-MISSOURI OIL COMPANY
Post Office Box 197
Kaiser, Missouri 65047-0197
314-348-4781

June 29, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington,DC, 20515

Dear Congressman,

Last year when the House and Senate passed the tax bill it was late in the session and little time was left for comments on Section 1703, the method of collection of the excise tax on motor fuel. The reason for the change, in my opinion, has some validity. However the cure, like some of the new wonder drugs has a side effect that will cause severe illness in some marketers' companies and could even be terminal for others. It is estimated that our company will need an additional $80,000.00 of working capital to continue in business, all of which we will have to borrow if we can.

Bankers, having just gone through some very rough years, are, to say the least, not very eager to lend money to a company that will not generate additional revenue to service the additional debt. Even if you are one of the fortunate few that have enough assets to borrow the required amount it will limit your growth for a number of years as the equity you might have used to finance a new unit will be used to secure this loan. The independent petroleum marketer has been for the last few years the only source of new jobs in the industry. The major players like the major players in all industries have been on a reduce the number of employees path for a number of years. It can be seen that even the companies that survive this change will become unable to contribute to a stronger job market in the future.

The uncollected tax problem however must be addresed and a simple solution is available.

1. Make the first purchaser of the product at the loading rack, be it pipeline terminal, marine terminal or refiner rack responsible for every gallon purchased and the supplier show a tax number on the bill of lading.

2. For auditing the tax number could be made up of two digits representing the sequence that a given state entered the union and the last four digits of that state's motor fuel tax number. A form can then be used to list each load by state code, by date, by bill of lading number, and by invoice number. In addition most states require the supplier to furnish them a list of all invoices showing tax exempt purchases of a given licensed distributer and this list could also be furnished to the IRS.

3. With the increased use of PC's the data could all be transmitted via a floppy or by using a modem. Even if this required 5000 licenses the task of auditing would be simple compared to the task of processing millions of individual tax returns.

I respectfully request serious consideration of the above.

Sincerely,

C. F Houghton

C. F. Houghton
President

Mid-South Sales, Inc.

520 Walnut Street, Helena, Arkansas 72342
Telephone 338-3464

June 29, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Rostenkowski:

We are strongly for changes in Section 1703 in the Technical Corrections Bill that would allow marketers to continue to pay excise taxes.

We want to maintain the right to collect and remit excise taxes. The loss of this right will cause a great hardship to the entire industry in terms of cash flow problems and potential competitive imbalances which will result if marketers are not allowed to collect and remit the excise taxes.

Your attention to this very important issue will be appreciated.

Sincerely,

William B Benton

William B. Benton

AMOCO
NIERMANN OIL COMPANY
R.R. 1 - BOX 16A HIGHWAY 3 SOUTH
RED BUD ILLINOIS 62278
PHONE 282-2344

July 7, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

This letter is being written with great concern about the Technical Corrections Bill (H.R. 2636 and S. 1350). Revisions to Section 1703 of the Tax reform Act of 1986 are strangly needed. If we lose our right to collect federal tax, it will greatly impair the growth and profit of our business.

Section 1703 was drafted hastily, without an assessment of the competitive imbalances it creates. Marketers suffer a loss of cash flow while their suppliers, with whom they compete, do not, leaving marketers at a competitive disadvantage in the marketplace. Section 1703 needs to be revised if these serious competive imbalances are to be remedied. The National trade association representing petroleum marketers, PMAA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same thime preserving the protections against tax evasion established in Section 1703.

Why not allow a refinery to sell to the licensed distributor tax free, and the licensed distributor will be allowed to resell only on a tax paid basis. This would stop the avoidance of federal exise taxes.

If this federal exise tax on gasoline is to be paid to the refinery, it is very important that the rule include a provision that the tax invoice the the jobber will receive allows ten days for payment.

Please consider my comments concerning this matter and urge your colleagues to add the PMAA's proposed amendment.

Thank you very much.

Sincerely,

Kenneth W. Niermann

Kenneth W. Niermann

NIMOCKS OIL CO., INC.

EXXON Happy Motoring!

P. O. Box 708
FORREST CITY, ARK. 72335

June 26, 1987

The Honorable Dan Rostenkowski
Chairman Committee on Ways and Means
U. S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

I am writing regarding the Technical Corrections Bill to the 1986 Tax Bill.

Under Section 1703 of the tax bill, small petroleum marketers, such as Nimocks Oil Company, Inc., will lose the right to collect and remit Federal Exise Taxes on motor fuels. Instead, these functions will be delegated to refiners and terminal operators, who are generally large, highly capitalized businesses.

This sedtion of the tax bill, if left intact, would deal a staggering blow to the approximately 5,000 small petroleum marketers who are struggling to survive in a fiercely competitive marketplace. It would create serious cash flow problems for us, which our more powerful competitors would not have.

I ask that you give your support to the amendmendment offered by Representative Jake Pickle of Texas. This amendment would, I believe, take care of the collection problems which were responsible for Section 1703, without severely penalizing smaller marketers, who contribute substantially to the economic health of our local communities.

Thank you for giving this matter serious consideration.

Sincerely,

A. B. Nimocks, Jr.

NORBERT E. MITCHELL COMPANY

NORBERT E. MITCHELL COMPANY
PETROLEUM PRODUCTS

P.O. Box 186, 7 Federal Rd. • Danbury, CT 06813 • (203) 744-0600
P.O. Box 58, Youngs Field Rd. • New Milford, CT 06776 • (203) 354-5518

July 2, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D. C. 20515

Dear Sir:

The Tax Reform Act of 1986 has certainly touched us all as business men, but unfortunately as a small business man, it threatens to be one more cause that may put this group of small marketers out of business.

Section #1703 which is scheduled to take effect on January 1, 1988 would shift the right to collect and remit the Federal gasoline excise tax from our Forty-three (43) Year Old Company to refiners and terminal operators. Our Company wants Section #1703 amended so that marketers would retain the right to remit the tax to the Treasury.

Being a marketer in Southern Connecticut and Eastern New York, there is no one who supports the end to excise tax evasion more than our company, but we believe evasion can be eliminated without adversely impacting the thousands of legitimate marketers who have remitted excise taxes to the Federal Government for the last thirty years.

Our family run business cannot afford to lose the cash flow which we have used to keep our products competitive to our customers. We cannot survive if our competitor/supplier has an opportunity to collect and use our money to a marketing advantage.

Please consider the above comments and if you have any question, I will make myself available to be in Washington for further explanation or discussion.

Sincerely,

NORBERT E. MITCHELL CO.

Donald D. Mitchell

Donald D. Mitchell

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NORCO

NORTHRUP OIL CO.
P. O. BOX 722
CHILLICOTHE, ILLINOIS 61523
(309) 274-2166
PEORIA PHONE 673-2356

July 3, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

RE: FET Excise Tax Collection

Dear Sir,

As an independent businessman, running a small family-owned petroleum distributorship that has managed to stay afloat for 60 years, I now plead with you to take action to prevent us from losing our right to collect and remit the Federal Excise Tax on gasoline.

We are constantly competing with major oil companies (Amoco, Mobil, Marathon, etc.) for large retail consumer accounts. These majors, even now, are often selling to our customers at 3 cents to 4 cents below the price they require of us for the same product, and allow 30 to 45 days credit while only giving us 10 days credit.

If we lose the right to collect the FET Tax it will severely reduce our cash flow while increasing the major oil companies' cash. It would also eliminate another class of trade for us to solicit and do business with.

The majority of the petroleum distributors are honest, enterprising businessmen, employing most of the people who make up this industry. Please don't let the Federal Government drive another nail into the coffin of the Small Businessman.

Sincerely,

Thomas E. Northrup, Pres.
Northrup Oil Company

Phone 697-4624

NUSSER OIL COMPANY, INC.
570 Border Avenue
P. O. Box 670
Elkhart, Kansas 67950

June 29, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

Regarding Section 1703 of the tax bill and the Technical Corrections Bill involving the gasoline excise tax collection issue.

As a gasoline marketer, I strongly support the current efforts of PMMA to amend Section 1703 so that marketers might continue to pay the tax on gallons purchased, rather than on gallons sold. If this amendment is not accepted, the result to our business would be an extreme drain on our cash flow and would create potential competitive imbalances.

Your committee's favorable consideration of PMAA's amendment to the Technical Corrections Bill will be greatly appreciated.

Sincerely,

John F Nusser

John F. Nusser
President

ORBIT OIL COMPANY
315 SCOTTSWOOD ROAD
RIVERSIDE, ILLINOIS 60546

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Mr. Rostenkowski:

I sincerely hope that you and your committee will reconsider the proposed changes in the method of collecting the federal tax on gasoline after January 1, 1988.

As a small independent gasoline marketer in the Chicago area, the proposed changes give my major competitors as well as my suppliers another advantage in the market place. These guys are tough enough to compete with let alone have our federal government help them.

Thank you for listening.

Sincerely yours,

Jack E. Story

Jack E. Story

PACE PETROLEUM CORPORATION
5001 PARK BLVD., SUITE 200
PINELLAS PARK, FLORIDA 33565

July 17, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
The Capital Building
Washington, DC 20515

Dear Honorable Rostenkowski:

Under the Section 1703 of the Tax Bill passed last year, Petroleum Marketers will loose privilege of collecting and remitting excise tax. PMAA is strongly lobbying for changes in Section 1703 that would allow marketers to continue to pay the tax ... but on gallons purchased, rather than on gallons sold.

Pace Petroleum Corporation would like to go on record that it supports this lobbying effort and feels that unless Section 1703 is changed, Petroleum Marketers will experience serious cash flow problems and potential competitive imbalances.

Very truly yours,

Everett M. Westcott

Identical letters from Everett M. Westcott were received on behalf of the following:

Petroleum Transport Lines, Inc.
Risser Oil Corp.

AMOCO

Palmetto Petroleum INC

U. S. 301 SO. • P. O. BOX 30 • DILLON, S. C. 29536 • PHONE 803-774-2797

July 21, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

I am writing to express my comments concerning the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

As a very small rural jobber, we depend on our cash flow for survival and in our twenty-six years of operation, we have never been late with any federal or state tax payments. The enormous windfall profits that would be reaped by the already greedy oil giants on short-term interest that would be made on switching this tax collection would be a total disservice to small businessmen and ultimately the consumer of America. I strongly protest the continued drift by the Federal Government to protect the giant conglomerates and ignore those of us who are small and unable to muster millions of dollars for lobbying efforts. In no way do I see where the public good could be benefited by squeezing small businessmen for the beneift of big oil companies and big business.

I, therefore, wish to add my voice to the small business public of America who are being strangled into obscurity.

Very truly yours,

PALMETTO PETROLEUM, INC.

JOE M. SCHAFER

Parent Petroleum

July 14, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman:

We would like to make our views known to you regarding the Technical Corrections Bill of 1987 - Specifically, the paying of Federal Excise Tax on gasoline to the refinery when we buy the product. We feel that this would put an unfair burden on us and others like us and the effects could be devastating on the industry. In an industry that is already so heavily taxed, this change in the cash flow could be the straw that broke the camel's back.

Please listen to the people who are representing our cause in this matter - they are speaking for all of us when they implore you to change this travesty. Our growth and profitability could be greatly impaired if you do not.

Thank you for your attention to this matter and we hope that you will act in the best interests of all parties.

Sincerely,

Peter Mancini

Peter Mancini
President

37W370 ROUTE 38 / ST. CHARLES, ILLINOIS 60174 / AREA CODE 312 584-2505

COMMONWEALTH OF VIRGINIA
HOUSE OF DELEGATES
RICHMOND

HARRY J. PARRISH
8808 BOND COURT
MANASSAS, VIRGINIA 22110

FIFTIETH DISTRICT

COMMITTEE ASSIGNMENTS
FINANCE
CONSERVATION AND NATURAL RESOURCES
MILITIA AND POLICE

29 June 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D. C. 20515

Dear Mr. Rostenkowski:

The Virginia Petroleum Jobbers Association has written you expressing their concern about a provision in the Tax Reform Act of 1986, having to do with the collections and remittance of the federal gasoline tax. Their letters explained the problems which will be encountered by the Independent Petroleum Jobbers and the resulting non-competitive position in which they will find themselves as they compete with major oil companies. I hope you had the opportunity to read their letter which was dated June 24 and that you will support their position to maintain a competitive gasoline market in Virginia.

I have a personal interest in this matter as my civilian occupation is that of chairman of the board of a petroleum distributorship. Any help that you can give me and the other 216 small business petroleum wholesalers located throughout the Commonwealth of Virginia, would be appreciated.

Sincerely,

Harry J. Parrish

Harry J. Parrish
50th House District

P. S. Enclosed is a copy of the letter of June 24.

NOT PRINTED AT STATE EXPENSE

Virginia Petroleum Jobbers Association, Inc.

E. D. CATTERTON, PRESIDENT
FRANK C. BEDELL, VICE PRESIDENT

P. O. Box 6344, Richmond, Virginia 23230, (804) 282-7534

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Angus I. Hines, Inc.
Suffolk, Va.

June 25, 1987

Hon. Dan Rostenkowski, Chairman
Committee on Ways & Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Rostenkowski:

The Virginia Petroleum Jobbers Association is seriously concerned about a provision in the Tax Reform Act of 1986 which will prohibit our member companies from collecting and remitting the federal gasoline tax as of January 1, 1988. Our members are 216 small business petroleum wholesalers located throughout the Commonwealth of Virginia. Most of our members are registered to collect and remit the federal excise tax on gasoline and have done so for many years without any loss to the U.S. Treasury.

The 1986 provisions will force our members to buy gasoline tax-paid from their major oil company suppliers, with whom they are also frequently forced to compete due to the complexity of the channels involved in the U.S. gasoline distribution system. The provisions will aggravate the problems of financing inventory and receivables that our members are already experiencing because of rising gasoline prices. Cash flow problems will also be made tougher for our people. It will become even more difficult for Virginia wholesalers to be competitive with the major oil companies.

We are told that the reason for the inclusion of the provision in the Tax Reform Act of 1986 was to prevent tax evasion. We have heard that the IRS and the U.S. Treasury Department say that they are unable to prevent evasion by auditing a long trail of tax free sales of gasoline between registered tax collectors prior to a sale to an unregistered purchaser, at which point the tax would have to be applied.

6716 PATTERSON AVENUE, RICHMOND, VIRGINIA

We believe we have a solution to the tax evasion problem, which would allow most Virginia jobbers to continue to function as registered tax collectors. Petroleum Marketers Association of America (PMAA), with which VPJA is affiliated, has come up with a proposal to allow marketers to remit taxes on purchases from a supplier, rather than on sales to customers, and there would be no tax exempt sales downstream. This would shorten the audit trail considerably, and allow IRS auditors to determine readily if tax evasion has occured, by matching a marketer's reported purchases with the sales total reported by his supplier. (In Virginia, our Department of Motor Vehicles is able to audit much more complicated series of transactions without difficulty.) The PMAA proposal also calls for marketers to demonstrate financial responsibility for two payment periods up to $150,000, to provide extra insurance against loss of gas tax liability to the U.S. Treasury.

We urge you and the other members of your committee to give favorable consideration to the PMAA proposal during your deliberations over the technical corrections to the 1986 Tax Reform Act.

The ability to continue to buy tax free from the major oil companies is crucial to the viability of some of our members and to the maintenance of a competitive gasoline market in Virginia and throughout America.

Sincerely,

Frank C. Bedell

Frank C. Bedell

Lofstrom-Edwards
PENINSULA OIL CO. INC.
PO BOX 151
[redacted] IRON MOUNTAIN 49801
PHONE (906) 774-5252

The Honorable Dan Rostenkowski
Chairman, Committe on Ways & Means
2111 RHOB
Washington, DC 20515

June 29, 1987

Dear Sir:

I am writing to help better inform you as to the extremely critical nature of HR 2636 and S 1350 (The Technical Corrections Bill). As a small businessman, in a very small community of 9000, I am a wholesaler and retailer of gasoline competing with major oil company service stations. This in itself is extremely difficult but HR 2636 and S1350 will make it impossible for me to compete with them any longer and I will have to close my doors. These bills would take away my opportunity to pay my Federal Gasoline Taxes directly to the Government every 15 days and force me to pay them to my supplier on each invoice daily. It means that the major oil companies would benefit from the float and garner interest on my money to force the price of gasoline down on the street. Eventually I would be forced to close my operations and 25 jobs would be lost to this community.

Once the small businessmen are gone, the major refiners will have a monopoly. Since they would be paying the tax on gasoline at the point of manufacture, they would maintain gasoline inventories at bare bones levels and operate their refineries to meet only their immediate needs. This could lead to spot shortages of gasoline and perhaps gasoline lines even if there was no actual shortage of crude oil or refining capacity. This rule change would encourage a shift in the manufacturing process for gasoline from refineries to terminals as suppliers send unfinished gasoline from the refinery to the terminal where it will be blended with feedstocks to finish the manufacturing process. This could give some companies a competitive advantage over others and could lead to massive excise tax evasion.

Petroleum Marketers Association of America, the national trade association representing the independent oil marketers in this country has developed a proposal that will resolve the competition problems created by Section 1703 with the least possible revenue impact while preserving the protection against tax evasion established in Section 1703.

I would strongly urge you to consider the PMAA proposals in regard to HR 2636 and S 1350 in order to preserve a strong foundation of independent businessmen in general and the independent petroleum marketer in particular. This will benefit the general public and the Nation as a whole.

Very truly yours,

Lofstrom-Edwards
PENINSULA OIL CO., INC.
Lee H Lofstrom
Lee H. Lofstrom, President

PMAA
PETROLEUM MARKETERS ASSOCIATION OF AMERICA
1120 VERMONT AVE., NW • SUITE 1130 • WASHINGTON, DC 20005 • (202) 331-1198

July 17, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In accordance with your solicitation of comments regarding the technical corrections bill to the Tax Reform Act of 1986, the Petroleum Marketers Association of America would like to submit these comments. PMAA very much appreciates your providing us with this opportunity.

The Petroleum Marketers Association of America is the largest representative of independent petroleum marketers in the United States of America. Through its 41 state and regional member associations, PMAA represents approximately 11,000 gasoline, diesel fuel, and heating oil marketers. These marketers sell over half the gasoline, 60 percent of the diesel fuel, and three quarters of the heating oil consumed in America today.

Background/Current Law

The 9.1¢ federal excise tax on gasoline is currently imposed on the first sale by a "producer" of that gasoline to a non-"producer". Under present law, a "producer" may include refiners, importers, wholesale distributors and chain retailers. The Department of Treasury estimates that approximately 8,200 companies throughout the United States have been issued a producer's license.

Until the late 1950's, only refiners or importers were allowed to collect and remit the excise tax on first sale. However, Congress recognized the significant and numerous disadvantages wholesale distributors suffered under this system. As part of the Federal Aid to Highways Act of 1959, Congress therefore changed the law to allow wholesale distributors to register as producers for tax purposes. Chain retailers (those with ten or more stations) were made eligible to become producers in 1984.

Many of these disadvantages occurred because, in the petroleum industry, unlike most other industries, the manufacturer of the product, the refiner, not only sells its product to wholesalers and retailers, but also actually competes with these marketers for wholesale and retail business. Until the law was changed in 2959, petroleum marketers were at a competitive disadvantage with refiners for several reasons, including: (1) marketers were forced to pay the tax to the refiner as part of the price of product, while refiners would have as much as two weeks before they would have to pay the tax to the government; (2) marketers would have to pay taxes on gallons purchased, thus paying taxes on gallons lost through shrinkage or handling, while refiners paid taxes only

Formerly National Oil Jobbers Council

on gallons actually sold; (3) tax exempt accounts (school districts, local governments, etc.) had an incentive to buy from a refiner rather than from a marketers because the refiner could serve the accounts on a tax exempt basis without any type of bureaucratic refund procedure; and (4) marketers faced an increasing cash flow burden not experienced by refiners because they paid the tax prior to the product being sold. This restricted marketer credit lines with both banks and suppliers.

Two further points in the way of background need to be mentioned. First, the Section 1703 changes agreed to last year were incorporated in neither the House-passed nor the Senate-passed bill--the change simply showed up as a result of conference committee action. Second, it is very much in the interest of PMAA membership to end excise tax evasion because people that don't pay excise tax clearly have an unfair competitive advantage over those who do pay the tax. PMAA testified to that effect on July 15, 1986, before the Ways and Means Oversight Subcommittee.

1986 Tax Reform Act: Section 1703 Provisions

As part of the Tax Reform Act of 1986, Congress changed the collection procedure once again. Under Section 1703 or the Act, effective January 1, 1988, the point of taxation is to be at the terminal rack, i.e. as product "breaks bulk." The tax is to be paid to the government by the terminal operator or the refiner nine days after the semi-monthly period. In addition, after product crosses the rack, there will be no tax exempt sales to any purchaser. All entities eligible to purchase tax exempt must apply for a refund of taxes paid. Treasury estimated this change would net the government an additional $1 billion over the next four years, a large portion of which would be generated in the first year from the accelerated tax payments. Additionally, the change was motivated by Treasury's assertion that it was unable to enforce the current system effectively, particularly against an organized crime element which has become involved in tax evasion schemes.

Marketer Concerns

Independent petroleum marketers, the vast majority of when are honest, legitimate businessmen, are very concerned about excise tax evasion, since from a competitive standpoint they are the victims of such evasion. However, the impact of the change made by Section 1703 is to force marketers to operate in an environment that significantly favors their competitors -- the refiners and terminal operators. As in the early 1950's, under the new law marketers will again be forced to buy their gasoline on a tax-paid basis, carry tax-paid inventories, and pay tax on volumes never sold due to natural evaporation. These are costs not borne by their refiner/supplier competitors. Marketers' cash flow will be adversely affected; and refiners and terminal operators will obtain a significant competitive advantage in that they will generally collect the tax from marketers long before the government will require that the taxes be remitted.

PMAA Proposal

The Petroleum Marketers Association of America has developed a proposal that would solve both the competitive and the cash flow problems created by the new law. PMAA's proposal maintains the basic structure of Section 1703 but modifies it in one essential respect. Under the proposal, as in Section 1703, the rack would continue to be the point of taxation and all tax exempt sales would be eliminated. However, in order to place all competitors on a level playing field, the proposal would allow eligible marketers to remit the tax directly to the government rather than require that they pay it directly to the refiner as part of the price of product.

Under this system, each marketer, as well as every other eligible taxpayer, would apply for a taxpayer I.D. number. When buying product at the rack the marketer would give its taxpayer I.D. number to the terminal operator or refiner. The refiner or terminal operator, in addition to reporting the total gallons which crossed its rack and remitting the taxes due to the Treasury on the gallons it sold to non-eligible taxpayers, would provide a list of the volumes sold to eligible marketers broken out by I.D. number. This "fool proof system" would provide IRS with the means to easily match the information provided by the refiner with the actual taxes remitted by the eligible marketer. Any discrepancy would be immediately apparent. Again, there would be no tax exempt sales after the product crosses the rack; and marketers without an eligible taxpayer I.D. number would not qualify as tax remittors.

PMAA's proposal is superior both to present law and to the solution provided in Section 1703. First, the system proposed is essentially a "self auditing" one, and could potentially save hundreds of thousands of dollars in IRS audit costs. Secondly, it allows the IRS to collect the taxes in the same time frame as under the new law, so there is no loss of revenue. Thirdly, it addresses marketers' cash flow problems and it is competitively neutral. While the population of remittors would remain large, the safeguards built into the system and the ease with which an audit could be conducted, vastly reduce the administrative costs and problems currently associated with enforcement.

The principal concern expressed by IRS with this proposal is that they still would be unable to enforce it adequately because they lack personnel to handle this system manually. Many of these same problems are also going to be prevalent under Section 1703 once IRS and Treasury come to grips with the type of regulatory program that is going to be necessary to bring about adequate enforcement.

To deal with these concerns, it is almost mandatory that the system of gasoline excise tax collections be computerized so that routine cross-checks can be made and violators can be identified. While there is certainly an initial cost of creating this system on computer, this cost should easily be recovered through more effective enforcement and less field personnel needed to conduct audits. In addition, since the Federal Highway Administration has a strong interest in seeing that every tax dollar is collected from gasoline excise taxes, they may be willing to help fund, from excise tax collections, part of the cost of computerizing excise tax collection data.

Again, PMAA appreciates the opportunity to submit these comments. Please let us know if we can be of any further assistance.

Sincerely,

Phillip R. Chisholm

Phillip R. Chisholm
Executive Vice President

PETROLEUM MARKETERS OF IOWA
BOX 6150 • PHONE 244-6273 • DES MOINES, IOWA 50309

DON FAUSER, PRESIDENT
TOM NELSON, VICE PRESIDENT
PAT MULGREW, TREASURER
E. A. KISTENMACHER, MANAGING DIRECTOR

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D. C. 20515

Dear Congressman Rostenkowski:

This letter concerns HR 2636, section 1703. Our industry requests your support of amendments to this section of HR 2636 to allow the registered gasoline distributor-marketers to continue to remit federal gasoline taxes.

The Petroleum Marketers of Iowa is a trade association representing distributors. Most of our members are registered to remit their own federal gasoline taxes. The present federal gas tax remittance procedures have worked well in Iowa. Few tax evasion problems exist in our part of the USA.

The amendments to HR 2636 section 1703 recognize that the petroleum marketplace reacts to gasoline tax remittance regulations. Cash flow, evaporation, tax exempt sales procedures, ethanol blends and net versus gross gallons are all legitimate concerns of the local petroleum marketer, Congress and the IRS. These issues deserve solutions and your support of corrective amendments to HR 2636.

The 1986 Tax Reform Act may have been to hasty when designing new laws on gasoline tax collection procedures. You have the opportunity to correct some of these mistakes with HR 2636. Please make sure the adopted amendments allow the local independent petroleum marketer an equal option of remitting federal gasoline taxes that his nearby refiner competitor enjoys!

Sincerely,

EA Kistenmacher
E. A. Kistenmacher
Managing Director

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PMAA DELEGATE, RON McGAUVRAN

PETROLEUM TRADERS
CORPORATION
1122 Thomas Road · Fort Wayne, Indiana 46804
(219) 432-6622

June 25, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

In response to your request of the PMAA membership for written comments regarding Technical Corrections of Section 1703 of the Tax Reform Act of 1986, we would like to offer the following information:

Petroleum Traders Corporation, like the majority of wholesale distributors, is an honest and responsible marketer. We accepted the obligation to be responsible for enforcing the federal excise tax laws when we registered to purchase gasoline tax free from our suppliers. It is an obligation we have taken seriously.

Petroleum Traders is highly aware that once we purchase a gallon of gasoline tax free, we must sell it correctly or the tax burden is ours to pay. We function on a profit margin which is often less than a cent a gallon, so there is no room for error. We have developed an excellent staff to handle our tax responsibility. We police our customer base for proper and logical tax status. We refuse to sell to any customer that is unwilling to remit the federal tax if they are unable to provide proof of their 637 registration.

Another asset we provide to the federal government is in the arena of educating our customers about the federal excise tax. Smaller marketers, end users, or people new in the business appreciate this knowledge and direction in comparison to the difficulty of getting answers from the regional IRS division which often requires waiting for a written response to an urgent question. Our experience over the years has brought us nearly every question possible and we have questioned the IRS completely. This educating process is something that refineries will be unwilling to put up with. Therefore, it will be even harder for the small businessman to follow the excise tax rules and find himself in violation or in an unequal position.

Furthermore, Section 1703 will create a tremendous cash flow advantage for major oil companies which already have an overwhelming advantage in the marketplace. The loss of cash flow to the wholesale distributor will drive some marketers out of business or minimally make them scale down their business to be able to afford the 1703 "prepaid tax plan". If Petroleum Traders has to pay the tax to its suppliers in 7 to 10 days and wait 20 to 60 days for payment from its customers, the impact on this corporation will be that it may have to borrow money to cover its customers' tax while the major oil companies are earning 1 to 24 days of interest on the tax monies they've collected from us and all the other marketers like us. The advantage to the major oil companies creates an even greater competitive imbalance.

Wholesale distributors, which are largely small businessmen, are responsible for keeping the marketplace competitive. If Section 1703 is not revised to address this imbalance, there may be far fewer small businessmen and far higher oil prices for the public.

Respectfully,

Michael B. Himes
President
Petroleum Traders Corporation

PORTS PETROLEUM CO., INC.

P.O. Box 1046
1337 Blachleyville Road
Wooster, Ohio 44691
(216) 264-1885

June 29, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways & Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing you concerning the proposed changes in the collection procedure of motor fuel excise taxes for which your Committee will determine the final procedure in the very near future.

Section 1703 will create a competitive edge for the refiner which is our supplier and our competition at the retail level of marketing. I do not believe your Committee is aware of this potential imbalance that it is creating for the small private brand retailer.

Tax evasion is a major problem, and I am in favor of it being stopped immediately, but your proposal does serious harm to many small marketers.

Has your Committee considered a tax collection system similar to what all states use, which is based upon deliveries in a given month, not on sales? If you went on a system like the states use, you could immediately compare on a monthly basis any marketers reported purchases to the state versus what was reported to the Internal Revenue Service.

I would be delighted to forward to your Committee copies of State Tax collection forms that we use monthly, which are Ohio, Michigan, Kentucky, Tennessee, Georgia, North Carolina, South Carolina, Pennsylvania. Please advise, if you desire these forwarded to you.

Additionally, please give serious consideration to the small businesses in this country, as most legislation being produced today is seriously harming the future of all small businesses, and I do not think it is your intent to have the Fortune 100 conducting all business in this country.

Thank you,

William C. Ports
PRESIDENT

The Total Petroleum Marketing Company
R & H MAXXON, INC.
P.O. Box 1077 Aiken, S.C. 29802 803-648-0458

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Honorable Rostenkowski,

I submit this letter in response to your request for comments concerning the inclusion of amendments to section 1703 of the Tax Reform Act of 1986. As you know the Act eliminates my ability as a wholesale distributor to collect the excise tax on gasoline.

We presently remit over $65,000 of federal excise tax twice a month. Removing this cash from our business will further penalize us in this very competitive business where price is the only advantage.

By removing the tax collection from our cash flow it will increase our costs of doing business by as much as .15 cents per gallon. In a business that nets less than .45 cents before taxes this is devastating.

At the same time some of our major competitors will not be affected by the law change. Our loss coupled with their no loss puts us at a further disadvantage. We would then be competing on a retail basis with the companies to whom we are remitting the Federal Excise Tax. Their investment gain in this extremely competitive business could be the advantage they need to deliver the final death blow to many of the small distributors in our state.

We presently employ over **85 employees** in Aiken County, South Carolina. Our **ability to properly reward them** and offer them **benefits would be adversely affected by the implementation of this Section of the Tax Reform Act of 1986.**

Please consider the proposal **submitted by our national association**, the Petroleum Marketers Association of America (PMAA) which amends Section 1703 so that marketers would retain the right to remit the tax to the Treasury.

Thank You.

Sincerely,

R.M. ROACH & SONS, INC.
P.O. BOX 831
MARTINSBURG, WV 25401

ROACH
OIL

TEXACO DISTRIBUTORS
333 E. JOHN ST.
(304) 263-3329

June 30, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways & Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

We have been a petroleum marketer for thirty-five years. The collection of gasoline excise taxes and the Technical Corrections Bill in process could have a severe impact on our business.

Section 1703 that would eliminate the marketers right to collect and remit the tax is the most detrimental aspect of the bill. Serious cash flow problems would be caused due to this proposal. Also, when we see refiners posting street prices that are apparently below our cost, the potential competitive imbalance loss of collection may create could be devastating for the marketer. The shifting of tax collection from the terminal to the refiners gate as suggested by the Joint Committee on Taxation would have a number of negative impacts. Down stream gasoline inventories would be kept at a bare minimum due to the higher cost of holding those excise tax dollars in inventory. This could create spot shortages as marketers try to obtain gasoline to meet their requirements. We also see unfinished product leaving the refinery, less tax, to be blended at the terminal with base stocks to complete the manufacturing process. This could create an even more severe competitive imbalance between the refiners and marketers.

In light of these problems, we are urging the committee to accept the amendment proposed by the Petroleum Marketers Association of America. The marketer must retain the right to collect and remit the excise tax if they are to remain competitive and survive.

Sincerely,

R. M. ROACH & SONS, INC.

Steven M Roach

Steven M. Roach

RAM CORPORATION

DISTRIBUTOR
PETROLEUM PRODUCTS

(512) 667-1141 • POST OFFICE BOX 20144 • SAN ANTONIO, TEXAS 78220

JUL 10 1987

July 7, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D. C. 20515

Re: HR 4343 Federal Excise Tax
Section 1703 New Tax Bill

Dear Respresentative Rostenkowski,

As you are aware, the referenced bill will change the point of collection of federal excise tax from the "historical collector", the gasoline marketer, to the refiner or terminal operator.

If this is allowed to happen, we are marketers would face a serious cash flow problem and also would be put at a competitive disadvantage with our refiner supplier because he would then have the advantage of collecting the tax from the marketer at the time that the product would "break bulk" and then finally remit the tax to the federal government some 15 days later.

We have been in business since 1968 as independent marketers of gasoline and diesel fuel and throughout the United States there are an additional 8,000 companies just like ours who make their livelihood out of serving and selling approximately two-thirds of all the gasoline and diesel fuels sold throughout the United States. The Treasury now with this new bill will take away the collection procedure of this federal excise tax from us as marketers just because some "crook" in the State of New York and possibly another handful throughout the United States have been guilty of tax evasion.

We ask your support in allowing the gasoline marketer to continue to collect the tax by making this correction in the technical corrections bill process.

Sincerely,

J.D. Marek

J. D. Marek

Rask Oil Co., Inc.
Hwy 167 East
Victoria, Il 61485

July 14, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman:

The word coming from Washington is very disturbing regarding the federal Tax Reform Act of 1986. As of January 1, 1988, I will be forced to pay the Federal excise tax on gasoline directly to my refiner (supplier) at the time the product is purchased. I normally use 645,000 gallons of gasoline per month for resale. Therefore, if I take this number of gallons (645,000) and multiply it by 9¢ per gallon, I will be forced to remove the total of $58,050 at a much quicker rate from my bank each month. There will be no float time which means no time to deposit this money in my bank to help with the local finances of my community.

Maybe when you see the cold hard facts, you will realize exactly what effects the Federal Tax Reform Act of 1986 will have on one of the last remaining small business segments in the United States. As Congress continues to pile more and more regulations and taxes on myself and my fellow petroleum marketers, they are slowly, but surely tightening the noose around our necks. Petroleum marketing will be the next business to disappear and join the ranks of other small businesses which have been unable to survive, like the corner grocery and neighborhood repair shop.

If you have any questions, please do not hesitate to contact me. Thank you for your help and concern in this matter.

Sincerely,

Lowell Rask

Lowell Rask

CONVENIENT
GASOLINE ®
REMOTE SERVICES, INC.
P.O. BOX 35580 • LOUISVILLE, KENTUCKY 40232 • (502) 451-3800

June 29, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

SUBJECT: Technical Corrections Needed to Section 1703 Of The Tax Reform Bill Passed In 1986

Dear Sir:

As you are aware, January 1, 1988 all Petroleum Marketers will lose the right to collect and remit federal excise tax on gasoline. I strongly support that taxes be paid on gallons purchased rather than gallons sold in an effort to eliminate all tax fraud. However, it is urgent that in the Technical Corrections Bill there be a change to correct and allow the gasoline marketers to continue to collect and remit the tax. If their suppliers are allowed to perform this function, then those suppliers will have the benefit of increasing their competitive position in the marketplace on a direct marketing basis. This competitive condition will put us and all independent marketers in an unfavorable profit situation which we will not be able to control.

I would appreciate your serious consideration to the impact that you will have on all small petroleum businessmen throughout the United States and would hope that you would support this technical correction in the Technical Corrections Bill.

Sincerely,

Gerald E. Wagner

Gerald E. Wagner
President
Remote Services, Inc.

RIISER OIL

RIISER OIL COMPANY, INC.
709 SOUTH 20TH AVENUE
P.O. BOX 239
WAUSAU, WI 54401
(715) 845-7272

CONVENIENCE STORES
GASOLINE
DIESEL FUEL
HOME HEATING OIL
MOTOR OIL
INDUSTRIAL LUBES

June 25, 1987

Hon. Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington D.C. 20515

Dear Mr. Rostenkowski;

I am writing to you to voice my concerns about the effect of Section 1703 of the Tax Reform Act. I understand that this Section will change the method of collection of federal motor fuels taxes effective January 1, 1988. The change will have the refiners collecting the nine cnets federal tax at the time we purchase product from them. They will then settle up with the government on a prearranged schedule. All that is really changing is that we are taking the funds that are due the government and letting the major oil companies have control of those funds for thirty days. This takes those dollars out of our state and local banks and puts them in the banks of the majors on Wall Street.

These funds that float in our state and local banks help our business as well as other businesses in our communities. These dollars on deposit with these banks allow the bank to invest, again probably locally, to create additional funds that can be used by farmers, potential home buyers, and other bank customers. I do not know why we should give these international oil companies the benefit of our locally generated dollars. What has Ashland Oil Company or Marathon Oil Company spent in the state of Wisconsin recently?

This change came about due to the fact that there were some individuals in our industry who were deceptive and found ways of avoiding the payment of the taxes. Why should our law abiding, tax paying business suffer to provide an easy out for a government agency? The Department of Revenue should do their homework and monitor their department, catch their thieves, indict them and prosecute them. Let them do their job.

I feel that this Section should be given a second look. Let's get the Department of Revenue doing their job and we will continue to do ours.

Sincerely,

David R. Frankhart
General Manager

TEXACO Mobil conoco Shell

ROANOKE OIL DISTRIBUTORS, INC. NO. 2
GAS AND OIL
812 MISSOURI AVENUE, N.E.
P. O. BOX 12443
ROANOKE, VIRGINIA 24025
PHONE 703/342-7879

July 2, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washinton, D.C. 20515

Dear Dan:

Under Section 1703 of tax bill last year, marketers will lose their right as of January 1, 1988 to pay excise tax on gasoline and diesel to remit twice monthly. This new ruling puts an undue hardship on Jobbers that is in the wholesaling of gasoline to commercial accounts, U.S. Government, and State Agencies. This will put a serious cash flow problem on the jobbers as it is proposed.

Since the price of gasoline and diesel fuel is on the upward swing, this is the most serious enactment we have faced in a long period. Your utmost consideration to repeal this section 1703 and allow the jobbers to continue paying as their sales require would be greatly appreciated.

Yours very truly,

Coy Bowling

Coy Bowling
Owner

ROGERS OIL COMPANY
P.O. BOX W
BEATTYVILLE, KENTUCKY 41311
AREA CODE 606   PHONE 464 3651

June 29, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Sir:

I am writing in regard to Section 1703 of the 1986 Tax Reform Act which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline. I strongly support the change which continues to allow marketers to collect and remit the tax on gallons purchased rather than gallons sold in an effort to reduce tax fraud.

I believe Section 1703 was drafted in haste, without a thorough assessment of the competitive imbalance it creates between marketers and their suppliers. For instance, marketers will suffer a loss of cash flow, while their suppliers, with whom they compete, will not. This places the marketer at a competitive disadvantage in the marketplace, while creating an unfavorable profit situation over which they have no control.

As the need of revisions to Section 1703 is drastically needed, the national trade association representing petroleum marketers, PMAA, has developed a proposal that will help resolve the competitive imbalance created in the bill, while at the same time will preserve, as much as possible, the protections against tax evasion already established.

As your support is greatly needed in the amending of Section 1703, I would appreciate your careful consideration of the resolutions proposed to help resolve the competitive problems it will cause.

Respectfully yours,

Logan Thomas

Logan Thomas,
President

ROMINE OIL CO., INC.
P.O. Box 47, Hwy. 70 East
De Queen, AR 71832
Phone: 501/584-3417

July 6, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
House of Representatives
Washington, D.C. 20515

Sir:

Romine Oil Company, Inc., a small business marketer, operating out of De Queen, Arkansas, would like to make the following comments regarding Section 1703 of the 1986 Tax Reform Act.

We highly support steps to end excise tax evasion, but believe evasion can be eliminated without adversely impacting the vast majority of legitimate marketers who have remitted excise taxes to the Federal Government for the past thirty years.

Section 1703 would cause serious cash flow problems for this small business. It would also create competitive imbalances between us, as a marketer, and refineries we deal with.

Thank you,

Larry R. Romine
Larry R. Romine

LRR/rk

Mobil

Schilling Petroleum Co.

1201 CENTERVILLE AVE. • BELLEVILLE, ILLINOIS 62221
PHONE: 233-4222

July 10, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman Rostenkowski:

This letter is written in regards to Section 1703 of the Tax Reform Act of 1986. It is my belief that Section 1703 was hastily drafted without an adequate assessment of the competitive imbalance it creates between the petroleum distributor and their suppliers. It is already tough enough competing against them without giving them anymore of an edge.

Also, Section 1703 will cause our cash flow, which we rely on greatly to operate, to suffer. On the other hand, the cash flow of the suppliers we compete against will not suffer. Again this puts us at a competitive disadvantage in the marketplace.

In conclusion, Section 1703 needs to be revised if the serious competitive imbalances are to be remedied.

Sincerely,

Bruce H. Cross

Bruce H. Cross
President

SERVICE SINCE 1921

SIMON OIL COMPANY, INC.

1316 MAIN STREET
NIAGARA FALLS, NEW YORK 14301
PHONE AREA CODE 716
285-9641 692-2987

June 29, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Re: SECTION 1703 - GASOLINE EXCISE TAX

Dear Mr. Rostenkowski:

As a gasoline marketer in the Western New York area, I am strongly opposed to Section 1703 of the new tax bill.

It is critical for the survival of my business to be able to continue to collect and remit the gasoline excise tax. If Section 1703 goes into effect as now written, it will create serious cash flow problems for all marketers that are not large refiners or terminal operators. Loss of the excise tax collection would also create competitive imbalances within our industry.

I urge you to change Section 1703 for all of the above reasons.

Sincerely,

Peter W. Barber

Peter W. Barber
General Manager

Smith Oil Company of Pendleton, Inc.
Post Office Box 68
Pendleton, South Carolina 29670

6 July 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
Washington, DC 20515

Dear Mr. Kostenkowski:

This letter is written in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

This elimination is just another "peg in the coffin" for small petroleum marketers, like us, in competition against the large corporations or refiners.

Not only will the severe loss of cash flow and the need for increased credit lines be a major blow but in selling gasoline from a bulk plant we lose at least 1% thru evaporation, etc. In other words, we do not sell the same gallons we purchase or are charged for! By having to pay the tax on each and every gallon we are charged for would be not only unfair but in many cases tragic, especially if and when federal gasoline taxes are increased.

We respectfully request that you amend Section 1703 so that we could continue to remit the tax to the Treasury, but if on a gallons purchased basis, we be given a "handling loss" adjustment.

Please help us!

Sincerely,

Jim Smith Jr

James D. Smith, Jr.
President

Smith Oil Co., Inc.
P.O. BOX 278
200 CAROLINA AVENUE
VARNVILLE, SOUTH CAROLINA 29944

July 10, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S.House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

I am writing in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which would take away the right of wholesale distributors as myself to collect and remit the excise tax on gasoline.

I am a small oil jobber. I am based in one of the poorest regions of the state of South Carolina. As few as ten years ago, there were seven oil jobbers in my county. Today there are only three. We are facing several requirements from various state and federal environmental agencies that are going to make us spend a great amount of money just to be in compliance. I try to do as much of my own work as possible to save money. I have tried every trick I can think of and read about to cut out as much expense as I can.

The secret to my survival has been my ability to generate cash flow. I need cash flow to be able to purchase equipment and supplies to operate. A good deal of my cash flow comes from my being able to remit taxes directly. Without this ability, all my available cash would have to be saved back to pay gasoline invoices. The major oil companies are already in direct competition with me. They do not need this extra advantage of this tax break just to them.

As I stated earlier, I am a small jobber in a poor region. In fact, I am the smallest in my county. Because of my size, I will serve small accounts that the bigger jobbers refuse to supply. If I lose this cash flow from this tax, I feel I will no longer be able to survive. I can no longer afford to credit these small accounts, because my cash flow will not allow it. Several of these small accounts are farmers, loggers and small business owners. Without my services, they will also fold. The departure of these small business people will eliminate an important link from the chain of competition.

Another point of concern to me is if the federal government follows through on eliminating our right to remit this tax, the state of South Carolina will follow suite. This would surely doom a great majority of oil jobbers.

I urge you to please consider the proposal of the Petroleum Marketers Association of America (PMAA) that would amend Section 1703 and allow companies such as myself the right to remit these taxes directly to the Treasury. So much these last few years has gone against my business, please help me win at least one battle.

Thank you.

Sincerely yours,

WH Smith, III

W.H.Smith, III
Vice-President

EXXON

SMITH-ROGERS OIL CO., INC.
P.O. BOX 308
MULLINS, SC 29574-0308
OWNER AND OPERATOR OF TIGER MART STORES

July 3, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkwoski,

This letter concerns section 1703 of the tax reform act of 1986.

We are a marketer of wholesale gasoline and diesel fuel.

We urge you to do everything in your power to amend this section so that we can continue to take title to product exclusive of taxes.

We buy and sell approximately 700,000 gallons per month. We cannot afford the harm that paying the taxes up front would cause us by loss of cash flow. Also we will be at a competitive disadvantage with our suppliers.

We have always remitted taxes honestly and timely. I urge you to amend section 1703 so that we will retain the right to remit taxes to the treasury.

Sincerely,

Smith-Rogers Oil Co., Inc.

W.L. Rogers, Jr.
President

SC/PMA
South Carolina Petroleum Marketers Association

June 26, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I submit this letter in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

The South Carolina Petroleum Marketers Association is a statewide trade association consisting of 250 independent small businessmen supplying petroleum products to the consuming public, to the residential fuel oil consumer, to commercial and industrial facilities, and other users of petroleum products. These member firms handle over 60% of the taxable gasoline and diesel fuel sold in the state and over 85% of the home heating fuel consumed in the state. Collectively, they collect and remit motor fuel excise taxes on 600,000,000 million gallons of taxable fuel a year.

If no change is made in the implementation of the ruling in Section 1703, many of these distributors, or jobbers as they are often called, may be forced out of business. They will suffer a severe loss of cash flow. To increase their credit lines may be impossible.

Their suppliers, with whom they very often compete, will conversely reap the benefits of the distributors' loss leaving the small business jobber at a distinct competitive disadvantage.

If Congress does indeed increase the excise tax on gasoline as appears may be the case, the situation will be even further aggravated. If having to pay 9.1 cents at the terminal to the supplier might break the distributor, certainly 19.1 cents, or 39.1 cents per gallon will.

Additionally, if the federal government insists on requiring payment "up front," the likelihood of the state following is enhanced. With South Carolina at 15 cents per gallon tax, the distributor is looking at at least 24.1 cents per gallon prepayment of taxes, and a possibility of 34.1 cents or even 54.1 cents per gallon.

These figures, without question would destroy the distributor network of petroleum products, not only in South Carolina, but in the nation. And, it this distributor network which has provided a vital service to the American consumer for more than half a

1809 Gadsden Street / Box 64 / Columbia, South Carolina 29202 / (803) 765-9570

century.

The South Carolina Petroleum Marketers Association respectfully requests your consideration of the proposal submitted by our national association the Petroleum Marketers Association of America (PMAA) which amends Section 1703 so that marketers would retain the right to remit the tax to the Treasury.

Thank you.

Sincerely yours,
David W. Reed
David W. Reed
Executive Director

Identical letters were received from:

Goldfinch Distributor, Inc., James B. Goldfinch
New Seaboard Petroleum, Ltd., George R. Covington

SEOMA

SouthEastern Oil Marketers Association

July 13, 1987

Thomas L. Osborne
Executive Director

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing in response to your request for comments concerning possible amendments to Section 1703 of the Tax Reform Act of 1986. That provision eliminates wholesale distributors from the list of those eligible to collect and remit the tax.

We believe that an amendment along the lines proposed by the Petroleum Marketers Association of America (PMAA) desperately needs to be adopted prior to Section 1703 becoming effective next January 1.

WHO WE REPRESENT

SEOMA is an association of independent marketers and "jobbers" who supply and/or operate in excess of 4,000 (in the aggregate) gasoline stations in 12 southern and border states. Our members sell in excess of 3 billion gallons of gasoline each year, meaning that they collect and remit to the Federal government some $300 million in motor fuel taxes each year (under current law).

While some of our member companies may belong to other associations as well, we are organizationally unaffiliated with any other trade association. Our endorsement of the PMAA proposal therefore,is a totally-independent action.

INDUSTRY STRUCTURE BACKGROUND INFORMATION

The motor fuel distribution system can generally be broken down into 3 components: refining, wholesaling, and retailing. The refiner typically retains ownership of the fuel while it is transported (usually by pipeline) to a terminal. At that point, ownership is transferred to a wholesaler, and the price at that point is referred to as the "rack price." The wholesaler transports it by truck to individual service stations (dealers, or retailers) where it again changes hands. The price at this point is referred to as "dealer tank wagon."

The problem with this neat division of the industry is that it exists on paper only. In fact, a high percentage of motor fuel passes through the hands of companies which operate in more than one of the three levels. Major integrated oil companies, for example, are refiners. But at the "rack," only a portion of their product is sold to independent wholesalers (branded "jobbers" or private-brand "marketers"). The balance remains in their ownership where they serve as their own wholesalers. Similarly, wholesalers (including integrated companies) sell only a portion of their product to independent "dealers" -- the balance is sold through their own direct-operated retail outlets. And even that is not the whole story; in most cases, the "independent" retail dealer never takes ownership of the motor fuel, merely selling on consignment product which is owned by the wholesaler.

Thus, at the retail (gas station) level, competitors include independent dealers, independent wholesalers, and refiners. Dealers and wholesalers are often in direct competition with their suppliers.

PRICING STRUCTURE

Historically, the "rack price" of gasoline has not included federal or state taxes; the "dealer tank wagon" price has included them.

Based on the current situation, the average wholesale price (all grades combined) is around 60 cents per gallon, the Federal tax is 9 cents per gallon, state taxes average around 15 cents per gallon, for a total "cost" of 84 cents per gallon. With retail (pump) prices averaging around 96 cents per gallon, this leaves only 12 cents per gallon to cover transportation costs (from the rack to the station), selling costs, overhead, and profit. Profit in this highly-competitive business is lucky to average 2 cents per gallon.

Such a low profit has been tolerable for two reasons: credit policies of suppliers, plus the remittance schedule for federal and state taxes, have allowed the product to be sold to the ultimate consumer by the remittance dates, for the most part. As a result, little money is tied up in inventory. This reduced capital requirement has made a very thin profit-to-sales ratio a tolerable return-on-investment ratio.

PROBLEM AREAS

Getting the precise quantities of motor fuel needed to the precise stations which need them is a Herculean task -- especially when you consider that it can take several weeks to transport gasoline by pipeline from a refinery in Houston to a market in the northeast. Thus, there have historically been "jobber-to-jobber" sales as those temporarily understocked sought to fill their needs from those temporarily overstocked.

Unfortunately, this legitimate type of transaction became a vehicle for tax evasion by a few. "Daisy chains" of jobber-to-jobber sales of as-yet-untaxed product could be used to obfuscate the fact that the tax was not paid. Eventually, the product would show up somewhere as "tax paid" even though it had not been. The government was being bilked out of millions of dollars, most of it going into the hands of organized crime rings.

SECTION 1703 -- PURPOSE

As we understand it, the primary purpose of Section 1703 was to eliminate this tax evasion. The approach taken to achieve this objective was to move up the collection point to "removal from the rack," thereby eliminating the possibility of evasion through "daisy chain" operations.

This approach has another short-term benefit to the treasury: since "rack removal" occurs several days or weeks prior to the current taxable transaction (sale to a retailer or an end user), there will be a one-time "bonanza" to the treasury in January of next year when tax suddenly becomes due on all product already pulled from the rack tax-free.

It is our belief that the revenues from the latter are, in fact, far more significant to the treasury than the funds achieved through stopping tax cheating. Given the budgetary pressures faced by Congress, this secondary effect may have become the motivating factor in the adoption of Section 1703 -- rather than the stated primary purpose.

We strongly support efforts to end evasion of motor fuel taxes. It is extremely difficult for a legitimate operator to compete with a tax-evading business which has a purchase-price advantage of 11% (if only Federal tax is evaded) to 29% (if both federal and state taxes are evaded) in an industry where net profit on sales averages under 3%!

On the other hand, we have serious reservations about the particular approach taken to solve the problem -- and also questions about the inherent fairness of the redefinition of the tax incidence.

17

SECTION 1703 -- EFFECTS & PROBLEMS

Section 1703 has effects on more than just the Federal treasury. It has serious (unintended, we believe) consequences within the motor fuel distribution industry. Allow me to use my members' aggregate figures to illustrate these points.

1.) It will significantly increase the capitalization requirement of independent wholesales and wholesaler/retailers.

Example: Under current law, my members "have use of" federal excise tax money for an average of 23 days from the time of the current "taxable transaction" to remission of the tax. ("Have use of" is in quotes, because the money may not actually be in their hands yet due to credit extended to dealers.) Based on an estimated average difference of 10 days between the current "taxable transaction" and that contained in Section 1703, plus the 23 days lost due to loss of collection rights, the new law will "move up" by an average of 33 days the date they must pay their Federal excise taxes. And based on $300 million in annual excise taxes collected, this amounts to a loss of $27 million in working capital!

2.) It will either reduce the profitability of independent gasoline marketing, or force a price increase to maintain profitability.

Example: Using the same numbers cited before, total profits from gasoline sales by my members are something between $30 and $60 million. Section 1703 will require them, in the first month, to increase their capitalization by $27 million -- something between 45% and 90% of current annual net profits! Although the big "crunch" will come in the first month, that level of additional capitalization will have to be maintained indefinitely.

3.) The Federal government is not the sole beneficiary of this "pinch" on independent wholesalers.

In fact, of the 33 days "float" being lost by independent wholesalers, only 10 days' worth is being transferred to the Federal treasury (the result of redefining a "taxable transaction.") The remaining 23 days' float is being transferred to the refiner. **Put another way, the changes required by Section 1703 will give to the Federal government a first-year "bonanza" of only $8.2 million from my members; however, it will give to the refiners who supply them an $18.8 million windfall from my members!**

4.) Section 1703 will have anti-competitive effects in the marketplace.

As noted earlier, refiners, independent wholesalers, and independent retailers all compete at the retail level. The "windfall" transfer of funds from independent wholesalers to refiners is unlikely to be translated into benefits (reduced prices) to all their customers. Far more likely, it will be used to benefit their direct marketing operations to the competitive disadvantage of their independent wholesale customers.

Our concern about competition from suppliers is not new, but is becoming more acute by the day. Major refiner/marketers are increasing their stake in the retail market -- particularly in growing urban areas -- both through new direct-operated or direct-supplied units and through complete or partial purchase of independent chains. While our members are divided over the question of refiner/retail divorcement legislation such as that proposed by Sen. Metzenbaum last year (for the simple reason that many view the majors as a prime potential "buyer" of their business should they decide to "sell out"), all are gravely concerned about the impact of supplier competition on their businesses in the short term. We are particularly concerned when we see a governmental action that has the effect of tipping the balance to favor the integrated distributor at their expense. Section 1703 is but one of several current examples of this. Other include: a) the recent relaxation of anti-trust rules pertaining to vertical integration and to market share, with no corresponding relaxation of rules pertaining to allowable activities by small businesses acting in concert; and b) proposed EPA "financial responsibility" requirements for underground tank owners and operators which can be met with ease by a refiner/retailer but which place an onerous burden on small and mid-sized wholesaler/retailers and on single-unit retailers. (On this last point, the EPA proposal will require my members (in the aggregate) to demonstrate nearly $600,000,000 in financial responsibility at about the same time that Section 1703 will be taking $27,000,000 from them. By contrast, the 7 "major" oil companies will only have to demonstrate an aggregate of $42,000,000 in financial responsibility -- which they will by able to fund entirely from the new "float" monies being transferred to them by Section 1703!)

If the Federal government does anything to impact the competitive positions of large versus small companies, it ought to be favoring small business -- which, after all, is more entrepreneurial and innovative, creates most of the new jobs inour economy, and which represents the major avenue for the working classes to move into the business-owner class. Section 1703 does just the opposite!

5.) It will reduce competition among suppliers of motor fuel to governmental entities.

Sales of motor fuels to governmental agencies are, under present law, exempt from the federal excise tax. That remains the case under Section 1703.

Under current law, such sales are deducted from total sales prior to remission of the tax. Under Section 1703, that will remain the case only for refiner sales to government. Wholesalers who are not refiners would be required under Section 1703 to remit the tax on total purchases -- including purchases for resale to government. After the sale to an exempt entity, the non-refiner wholesaler can then apply for a so-called "expedited" refund of the tax on the exempt sale.

It is hard for us to understand why the government would even consider placing such an inequitable impediment to competition on small businesses in their dealings with governmental agencies. Surely even the most naive cannot conclude that this will not result in higher prices to government -- offsetting at least in part the increased revenue on the tax side.

6.) Section 1703 unfairly denies non-refiner wholesalers any allowance for shrinkage.

To the non-initiate, "shrinkage" of gasoline may sound like a phony issue. Let me assure you it is not!

There are three major areas where shrinkage is a factor:

a.) Volumetric changes due to temperature changes. Gasoline, like most liquids, expands and contracts as its temperature goes up or down. Ten gallons of gasoline at a 90 degree temperature will, when cooled to 60 degrees, be less than 10 gallons. Since the non-refiner wholesaler is picking up his supply at a rack where it has been stored in metal tanks exposed to direct sunlight, but resells it from underground tanks where temperatures are cooler, he is almost always on the losing end of this natural phenomenon.

b.) Evaporation. Gasoline is a volatile liquid, meaning that it tends to evaporate. This is such a serious problem that the EPA is focusing primarily on gasoline vapors in its various attempts to reduce air pollution. In areas where "Stage I Vapor Recovery" is required, EPA mandates expensive equipment to recapture the gasoline vapors which build up in underground station tanks and in gasoline delivery trucks -- something that it would not do if evaporation were a "minor" factor. Under Stage I rules, those vapors are recaptured and converted back to gasoline. Fine. But the vapors are from gasoline which has already been purchased by the independent wholesaler, and are converted back to gasoline owned by the refiner! Under Section 1703, the wholesaler will be required to pay federal taxes over and over again on the gallons "lost" to shrinkage, while his refiner-competitor will get the benefit of both the reconstituted additional gallons recovered and, apparently, an allowance for his competitor's shrinkage!

c.) Leaks, spills, and theft. While perhaps the case can be made that such types of shrinkage should be taxed, to encourage operators to take effective measures to prevent them, it should nevertheless be noted that the end effect is a tax of greater than what is statutorily authorized on each gallon of gasoline actually sold for highway use.

7.) Section 1703 will counteract the benefits of Federal policies on ethanol-blended fuels.

As you are aware, gasoline blended with 10% ethanol is exempt from 6 cents of the 9 cent tax on motor fuels. This exemption is consistent with three basic policies of the Federal government: to promote domestic energy security, to promote American agriculture, and to promote a cleaner environment.

Section 1703, by requiring that the full 9 cent tax be paid on gasoline for use in blending with ethanol and then obtaining a refund on the end product, will significantly reduce the attractiveness of the tax incentive.

At this point, virtually all ethanol blending is being done by independent wholesalers. Refiners are reluctant to blend for one basic reason: any alternative fuel which reduces demand for gasoline will reduce the value of their main product and the long-term value of their crude oil reserves. Not only are they reluctant to blend with ethanol themselves -- they have engaged in aggressive efforts to have state and federal tax incentives for ethanol blending repealed, and have engaged in "public relations" efforts to undermine public acceptance of "gasohol."

Section 1703 penalizes those firms who have been engaging in ethanol blending in conformance with stated Federal policies, and leaves the full benefit of the tax exemption available only to those with a vested interest in opposing alternative fuels!

8.) Section 1703 will have a magnified impact beyond what is contained in that law itself.

The numbers contained in points 1, 2, and 3 above are based on the current federal excise tax of 9 cents per gallon. As you are well aware, there is widespread discussion in Congress of a significant increase in that tax rate.

If the tax were raised by (say) 10 cents per gallon, the anti-competitive impact on my members would be crushing. It is when prices at the pump are going up that price competition is at its stiffest -- with various retailers holding off price increases as long as possible to build their customer base. If Section 1703 were in effect at the time such an increase in the tax became effective, you can calculate the results yourself: my members would transfer some $30 million in the first month to their suppliers -- who would in turn have "free use" of those funds for some 23 days, and would no doubt use that float to enhance their competitive position.

Beyond possible Federal tax increase, the effects of Section 1703 will be magnified by state action. Most state tax authorities try to work closely with the IRS in the area of motor fuel taxes -- conducting joint audits, exchanging information, etc. To facilitate this, states tend to make their regulations parallel those of the Federal government. If -- as is likely -- the states were to follow **the Federal lead in eliminating** wholesalers as motor fuel tax **collectors, the effects of Section 1703** which I have outlined thus **far would be magnified by a factor of over 2.5 times!**

MOST OF THESE NEGATIVE EFFECTS ARE UNNECESSARY

The provisions of Section 1703 changing the "incidence" of the motor fuel tax to the point of "removal from the terminal" accomplish everything (revenue-wise) the section intended: additional collections through elimination of tax cheating, and one-time additional revenue by effectively shortening the "float" period by approximately 10 days.

A case could be made, I believe, that regardless of what the law says, the motor fuel tax is an end-user tax (otherwise why the exemptions for certain end users and certain end uses such as governmental agencies, off-road use, etc.) Taking that approach, one could argue that the taxable transaction ought to be sale to the end user -- that no business ought to be required to remit to the government taxes on its customers which have not yet been paid to them and which, depending on who is the purchaser, may not even be taxable! Given an appropriate float period, however, the effect is not that onerous -- in fact, even with taxing the rack removal, an average 23-day "float" period for remittance will mean that the tax will have been collected from the consumer prior to its being remitted to the government. Thus, the change in the collection point itself is neither grossly unfair nor unbalanced in its effect.

The problems are not in those areas; they are in the transferring of collection responsibility to refiners. This is a gratutitous and onerous provision whose sole justification is the argument by IRS that it will be "easier" to collect funds from the small number of refiners than it is from a large number of independent wholesalers. (IRS has a legitimate interest in promoting a system which creates audit trails to ease enforcement. It does not have a legitimate interest in determining how many or how few taxable entities exist. If it did, we would no doubt be hearing proposals that all enterprise in this country be conducted by the Fortune 500, since that would be "easier" for the IRS than having millions of small businesses to monitor!)

OUR PROPOSED SOLUTION

As noted earlier, PMAA (with which we are not affiliated) has drafted a proposed amendment to Section 1703, which we strongly endorse. It would be revenue-neutral vis-a-vis Section 1703 as currently worded. It would leave a clear and absolute audit trail, eliminating tax evasion as effectively as the current wording. And, yes, it would cost my members approximately $8.2 million in lost working capital. But it would not cost them more than the government gains, would not force then to subsidize their supplier/wholesaler competitors, and would not subject them to multiplied effects in the event of a Federal or state motor fuel tax increase. In short, it allows the government to achieve its tax collection goals while preserving competition in motor fuel marketing.

We urge its adoption as a part of the technical corrections tax act as soon as possible.

Sincerely,
Thomas L. Osborne
Thomas L. Osborne
Executive Director

SEOMA

SouthEastern Oil Marketers Association

Thomas L. Osborne
Executive Director

July 8, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I submit this letter in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline and diesel fuel.

The Southeastern Oil Marketers Association is a twelve state association of gasoline and diesel fuel marketers, independent of the major oil companies. Our membership includes independent small and large businessmen supplying petroleum products to the consuming public, to the retail trucking industry, and other users of petroleum products. These member firms represent over 5,000 gasoline and diesel fuel outlets in the Southeast. Collectively, they collect and remit motor fuel excise taxes in excess of four billion gallons of taxable fuel a year.

If no change is made in the implementation of the ruling in Section 1703, many of these independent businessmen may be forced out of business. Some have stated that they will be forced out completely, while others say if not, they will certainly be compelled to curtail any expansion plans that they might be entertaining, presently. This is a tremendous potential for a loss of jobs as well as a loss of prospective jobs. Most of the jobs are filled with minimum wage or slightly above minimum wage employees that make up the bulk of our nation's unemployment and unemployable problems.

The severe loss of cash flow and pressure on lines of credit is only part of the problems this would impose on us. We are in a very competitive business, mostly in convenience stores. There is tremendous pressure placed on us by new EPA underground tank regulations; by new restrictions of our insurance carriers; by legislative proposals to raise the minimum wage, restrict our use of the polygraph, and increase excise tax on gasoline and diesel. Now we face this additional government imposed burden which will benefit our oil company suppliers at our expense. Most of these suppliers are our competitors in direct operated convenience stores and truck stops. They already enjoy a price advantage which we must try to absorb. This additional edge would add to their competitive advantage.

The main argument for this change is to eliminate any tax evasion. I seriously doubt that much, if any, tax evasion is occurring, if all states are as thorough in their audits as our South Carolina Tax Commission. I have no reason to believe otherwise since the states now collect the largest share of these taxes and are properly assigned the task of audits.

Thank you.

Sincerely yours,

Howard Vincent
HOWARD P. VINCENT, President

SPROCO

SPREEMAN OIL COMPANY
1355 WARREN AVENUE
DOWNERS GROVE, ILLINOIS 60515
(312) 968-5620

June 30, 1987

[redacted]

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Sir:

My letter is concerning the proposed revisions in section 1703 of the tax reform act of 1986.

I would like to bluntly state that the requirement to have the refiners collect the excise tax on gasoline at the loading rack would be a travesty against the small businessman.

It's tough enough competing against the big guys, but to have the government on their side is just not fair. How do we handle gasohol, governmental agencies and charitable institutions? Pay the tax and wait forever for a refund?

What does it do but kill our cash flow? The refiners come out gaining what we lose. I say leave it like it is.

Please help correct this injustice before it is too late.

Sincerely yours,

Gerald Spreeman

Gerald Spreeman
President

[redacted]

SPROTT OIL COMPANY, INC.
SOUTH MILL STREET · P.O. DRAWER 1332
MANNING, S.C. 29102
(803) 435-8809

July 1, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U. S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

As a small, independent petroleum marketer, I am very much concerned over the impending legislation that changes the method in which we pay federal excise taxes.

Under section 1703 of the tax bill passed last year, we will lose the right to collect and remit this tax. This will immediately create a very real and very serious cash flow for us and at the same time will put us at a definite disadvantage with some of our main competitors, the refiners and terminal operators. They will use our money to fight us in the marketplace. I'm sure that they are now rejoicing over the increase in operating funds that they will receive because of this legislation.

Not only will we have to borrow additional moneys to pay these taxes, but many marketers will also have to increase their credit limits with their suppliers, which in many instances will be impossible.

If congress increases the excise tax on gasoline and diesel fuels, out problem will be compounded, and if the states decide to follow suite (which they probably will), and have us pay at the terminal then the distributor network would vanish. Again, the major oil companies would be delighted to eliminate this segment of their competition in this fashion.

This is a terrible piece of legislation, and I urge you...as honestly as I know how...to at least consider the proposal submitted by the Petroleum Marketers Association of America whereby marketers would retain the right to remit the tax to the treasury.

Thank you very much.

Very truly yours,

H. B. Sprott, Jr.

ELLOREE, S.C. – MANNING, S.C. – SUMMERTON, S.C.

EXXON

SPRUILL OIL COMPANY, INC.
DISTRIBUTOR
P.O. BOX 1083
CARROLLTON, GEORGIA 30117-1083

LEWIS C. SPRUILL
PRESIDENT

PHONE:
(404) 834-0838

June 26, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Subject: **Federal Excise Tax**
Motor Gasoline

Dear Mr. Rostenkowski:

My family and I own and operate a relatively small petroleum distribution business with headquarters in Carrollton, Georgia. We serve Exxon branded petroleum products to retail outlets and consumers within a six (6) county area of West Georgia. Most of these retail outlets are small "Mom and Pop" type facilities.

My purpose in writing you is to respectfully request consideration toward changing Section 1703 of the Tax Reform Bill passed last year.

As you know, under the provisions of that tax bill, small independent petroleum marketers like myself will be required to pay the Federal Excise Tax on motor gasoline at time of purchase from our suppliers effective January 1, 1988. At the present time, we have been allowed to pay the Federal Excise Tax directly to the Federal Government after sales are made. For example, on all sales of motor gasoline made during the first fifteen (15) days of a given month, the taxes are paid by us on the 24th day of the month following that fifteen (15) day period. Likewise, we pay the taxes for the last fifteen (15) days of a given month on the 9th day of the following month. At the present time, our Federal Excise Tax on gasoline amounts to $80-85,000 per month. Under the provisions of this new tax bill, I will be severely handicapped by having to pay the taxes at time of purchase. As a result, the major oil companies will realize tremendous benefits by having access to the tax monies from marketers such as ourselves. A small family-owned business such as ours simply cannot afford to pay these taxes upfront which would more than wipe out our operating capital and necessitate substantial loans in order to stay in business.

Therefore, I respectfully request that consideration be given to allow us to continue to remit our Federal Excise Tax after the sales are made as is presently permitted.

Sincerely,

SPRUILL OIL COMPANY

L C Spruill

L. C. Spruill
President

Stockman Oil

Mobil
AUTOMOTIVE — INDUSTRIAL LUBRICANTS
PHONE 803-223-8486

1138 REYNOLDS AVENUE
GREENWOOD, SC 29646

July 16, 1987

The Honorable David Boren
U.S. Senate
Washington, DC 20510

Subject: Gasoline Tax Collection Procedure

Dear Senator Boren,

Our company is in the gasoline business. We sell about 500,000 gallons per month. Currently we pay the federal tax twice a month, after the sale. I understand new regulations would require us to pay the tax when we buy gasoline. As you can see, we will be paying tax before we collect it, severely hampering our business.

I believe this would fatally impact many small jobbers. Others like myself, would be impacted to the extent that there would be no capital for growth, for wage increases, employee benefits, civic contributions, or capital upgrades.

Senator, I know times are tough, but don't require us to pay taxes before we can collect them.

Often our strongest competitors are major oil companies. When we bid on gasoline & diesel fuel for commercial accounts we don't collect for about ten days, if we are lucky. If we have to pay the tax up front, the major oil companies will have a distinct price advantage. They can even use our tax money for a few days float in interest bearing accounts.

Please consider other alternatives to the present 1986 tax bill procedure. Its bad that a few rotten apples have spoiled the whole crop.

Thanks for your consideration.

Sincerely,

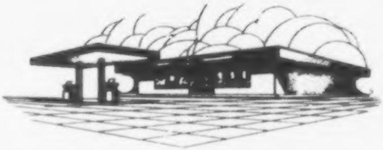
Pierce Stockman

Pierce Stockman

STOP -N- GO
CONVENIENCE STORES

Stop-N-Go of Madison, Inc.
Rockford Stop-N-Go, Inc.
2934 Fish Hatchery Road
Madison, Wisconsin 53713

Phone: 608-271-4433



COMMITTEE ON
RECEIVED
JUL 6 1987
WAYS AND MEANS

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means 2111RHOB
U. S. House of Representatives
Washington, D. C. 20515

Dear Representative Rostenkowski:

I represent Stop-N-Go of Madison, Inc. and Rockford Stop-N-Go Inc.; a chain of 53 privately held convenience stores in Southern Wisconsin and Northern Illinois. We consider ourselves a small operator although we generate retail sales of over $30,000,000 annually.

Of our 53 locations, 27 sell gasoline. Our monthly gallonage is about 1.5 million. I write today to inform you of our opposition to the Technical Corrections Bill; HB 2636, Section 1703.

It is imperative that the federal gasoline excise taxes continue to be collected and paid on gallons sold, by the marketer.

One can easily see that the loss of cash float that this would create could be devastating to some operators. Keep in mind also, that most of our suppliers are also our competitors. Certainly the intention here was not to create a competitive imbalance. By paying the excise tax on gallons purchased versus gallons sold we give this valuable float advantage to our competitor.

Somehow this seems Un-American to me.

Sincerely,

John N. Becker

John N. Becker
Vice President Store Operations

Tennessee Oil Marketers Association

430 ENOS REED DRIVE, P. O. BOX 101334, NASHVILLE, TENN. 37210

June 25, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

RE: Technical Corrections Bill (H.R. 2636/S. 1350)

Dear Representative Rostenkowski:

This letter is to urge your committee to consider amending Section 1703 of the Tax Reform Act of 1986, concerning remittance of the federal excise tax on gasoline.

Our national trade association, representing petroleum marketers, PMAA, has developed a proposal which would resolve the competitive problems created by Section 1703 with the least possible revenue impact, and would preserve protections against tax evasion.

Section 1703, as it now stands, does not take into account the competitive imbalance it creates. Marketers will suffer a loss of cash flow while their suppliers, who are also competitors, do not. This is a serious competitive disadvantage in the marketplace.

We respectfully request that the Committee on Ways and Means consider the proposal as submitted by PMAA.

Sincerely,

Marylee Magee

Marylee Magee
Executive Director

Tioga Petroleum Co., Inc. P.O. Box 158, Canoe Camp, Mansfield, PA. 16933

June 30, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Ref: Section 1703 of the 1986 Tax Bill

Sir:

We are a small petroleum marketer in North Central Pennsylvania, supplying a full line of petroleum products.

In dealing directly with consumers we have to give credit terms i.e., farmers, household heat, truckers, small garages, etc. Part of the reason we are able to extend this credit is the tax collecting privilege of collecting fuel taxes. This gives us 30 days in which to submit the tax to the government. Without this privilege we would be unable to extend credit.

Now, the unfortunate part is that the Section 1703 makes an exception for several of my competitors who will still have this privilege. These are the large distributors who are terminal owners. This will create a very unfair marketing advantage over a small local marketer such as ourselves.

Please do not stand still and put the small businessman out of business. We are essential to the grass roots of America.

Please vote to allow us to continue collecting taxes and amend Section 1703 of the tax bill.

Respectfully submitted,

David T Cummings

David T. Cummings
President

TORCH OIL CO.

1339 S. Meridian Rd., P.O. Box 157 Rockford, Ill. 61105
Phone 815-965-0670 Ill. 1-800-652-6626

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Honorable Rostenkowski:

Torch Oil Company would like to urge revisions to Section 1703 of the Tax Reform Act of 1986.

The following points are the reasons we feel this revision is very important to our business.

A. Section 1703 was drafted hastily, without an assessment of the competitive imbalances it creates;

B. Marketers suffer a loss of cash flow while suppliers, with whom they compete, do not, leaving marketers at a competitive disadvantage in the marketplace;

C. Section 1703 needs to be revised if these serious competitive imbalances are to be remedied; and

D. The national trade association representing petroleum marketers, PMAA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same time preserving to the greatest extent possible the protections against tax evasion established in Section 1703.

Your efforts and consideration in this matter would be appreciated.

Yours truly,

Terry M. Firch

Terry M. Firch
President

Self Way

TRAVELERS PETROLEUM, INC.
2315 NORTH MAIN STREET, SUITE 224
P.O. BOX 1426, ANDERSON, S.C. 29622
803-225-4676

July 6, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

Reference is made to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates petroleum marketers from the list of those eligible to collect and remit the excise tax on gasoline.

Travelers Petroleum, Inc., is an independent petroleum marketer, who presently remits motor fuel excise taxes direct.

If revisions are not made in the implementation of the ruling in Section 1703 whereby we will be permitted to continue remitting motor fuel excise taxes direct, we will be faced with a serious economic crisis, i.e., loss of cash flow and the requirement for increased lines of credit due to the increased cost of merchandise because of the tax being included in its cost at time of acquisition.

I respectfully request your consideration of the proposal submitted by our national PMAA (Petroleum Marketers Association of America) which amends Section 1703 so that we may continue the right to remit subject tax direct.

Thank you.

Yours truly,

Joe F. Brandt
President

Valley Petroleum

July 14, 1987

Congressman Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Congressman:

We would like to make our views known to you regarding the Technical Corrections Bill of 1987 - specifically, the paying of Federal Excise Tax on gasoline to the refinery when we buy the product. We feel that this would put an unfair burden on us and others like us and the effects could be devastating on the industry. In an industry that is already so heavily taxed, this change in the cash flow could be the straw that broke the camel's back.

Please listen to the people who are representing our cause in this matter - they are speaking for all of us when they implore you to change this travesty. Our growth and profitability could be greatly impaired if you do not.

Thank you for your attention to this matter and we hope that you will act in the best interests of all parties.

Sincerely,

Peter A. Spina

Peter A. Spina
President

24 W 750 ST. CHARLES ROAD / WHEATON, ILLINOIS 60187 / AREA CODE 312 668-014

VOLTA OIL CO INC
V O
Volta
OIL CO., INC.
"SERVICE YOU CAN TRUST"
P.O. BOX 1040 - ROUTE 44 • PLYMOUTH MASS 02360 • PHONE 746-1341

July 2, 1987

Honorable Dan Rostenkowski
Chairman
Committee On Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

Reference the technical correction bill to the Tax Act of 1986 section 1703 as written prohibits independent wholesalers to collect the Federal Gasoline Excise Tax and remit it to the Federal Government. Instead we must pay our suppliers this tax at the time of purchase.

When this provision becomes effective in Janurary, 1988 we as a small business trying to compete with the large refineries and terminal operations will lose our ability to acquire our local govermental and other exempt gasoline business since we will no longer be able to sell this gasoline tax free. In addation our expense will increase from the loss of cash flow that will result in remitting our taxes at time of purchase to our supplier. Moreover our suppliers (Reference and Terminal Operations) expense will be reduced from the additional cash flow.

Moreover many of our Farm and Commercial accounts (also small Businesses) rely on our ability to finance their purchases of gasoline for up to sixty days. With the loss cash flow resulting from excise tax prepayment and from our suppliers shortened credit terms, we will not be able to extend such terms, resulting in many of these bussinesses not being able to continue operating.

In summary, I urge you to adopt a correction to section 1703 of the 1986 tax revision act which is not "Pro Big Businesses". In order to keep the petroleum market competitive, we smaller merchants must be allowed to remitt our Federal Excise Taxes on a **similar** bases as do our large refinery competitiors do.

I look foward to your committee's favorable response to this correction of the undue hardship caused by the 1986 tax act.

Sincerely,

James Garrett

James S. Garrett
President

W. H. BRISTOW, INC.
DISTRIBUTOR GULF OIL PRODUCTS

TELEPHONE 803-662-4311
POST OFFICE BOX 1030
FLORENCE, S. C. 29501

TELEPHONE 803-393-2896
POST OFFICE BOX 158
DARLINGTON, S. C. 29532

July 7, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing to you in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

My company is a small wholesale petroleum distributor serving some fifty retail gasoline outlets and fifteen hundred commercial, farm, and home heating accounts in Northeastern South Carolina. For many years the ability to collect the federal excise tax on gasoline has helped with my cash flow in the operation of my business. Now under the proposed changes to the tax law I will no longer be allowed to collect and remit the Federal excise tax on gasoline.

I have conservatively estimated that it will require an additional $100,000.00 investment in my small business if I lose the ability to collect the Federal excise tax on gasoline and additionally am required to pay the Federal tax on gasoline at the time of purchase from the terminal. This additional investment in my business would bring me no return and will be extremely difficult to recover in today's market place with low volumes and small margins.

Should the Congress increase the Federal excise tax on gasoline this would only compound my problem by requiring additional investments in my business to take care of the tax increase on my gasoline inventorys. I would also be required to request larger credit lines with my suppliers in order to take care of the gasoline tax at a time that suppliers are looking very closely at trying to limit or reduce the credit lines of their small distributors.

In short, the change in the law which would not permit me to collect the Federal excise tax on gasoline would severly impact my small business and I would urge that you give serious consideration to the proposal submitted by our national trade association the Petroleum Marketers Association of America which amends Section 1703 so that marketers, like myself, would retain the right to remit the tax to the Treasury.

Thank you very much for your consideration in this matter.

Yours very truly,

W. H. Bristow, Jr.

Wayne Distributing, Inc.
Petroleum Products
Rt. #2 Box 13
Red Bud, Illinois 62278

June 24, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

Dear Mr. Rostenkowski:

As a small petroleum marketer selling under 2 million gallons a year, I would like to voice my opposition to the proposed change in Section 1703 of the Tax Reform Act.

I sell Amoco and Phillips "66" products. Both of these suppliers have in the past and will continue to compete with me. They have taken customers from me by offering them product for a price less than they charge to me. They also sell through their company-owned stations at prices under my cost, forcing my street prices down to stay in business. The changes called for in Section 1703 will give my suppliers an added advantage in the marketplace and will give me ANOTHER disadvantage.

Secondly, I lose about 10,000 gallons of gasoline to handling and evaporation (and short loads) every year. This new proposal will have me paying 9.1 cents on this product that is not saleable to me. This is another tax directly on me that I cannot pass to the consumer. It is dead expense. I cannot afford to swallow it and I can't add it to my cost because my supplier already has the advantage of price in the marketplace.

Third, why must we pay taxes before we collect them or even bill the customer for product and taxes. This puts the burden of tax again on me. I am, at that point, borrowing money to support the Federal Government until I can get the customer to pay me.

Fourth, the old system does not need changing. For those selling exempt to municipalities, schools, etc., and alcohol blending, the tax liability can be determined at the point of sale which is as it should be.

Proposals such as this should not even be considered. They are conceived with NO THOUGHT TO THE CONSEQUENCES, only short-sighted greed to grab money more quickly for the government.

Please consider carefully the PMAA proposal that will help resolve the competitive problems caused by Section 1703 while protecting against tax evasion.

Sincerely,

Wayne N. Mesnarich

Wayne N. Mesnarich

WILLIAM C. PEPPER, INC.
310 NORTH RACE STREET
GEORGETOWN, DELAWARE 19947
302 - 856 - 2555

July 1, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Sir:

I am a gasoline distributor concerned with the bill scheduled to take effect January 1, 1988 concerning the collection of gasoline excise taxes. If it takes effect as scheduled, I will have to borrow an additional $75,000 to run my business, a cost my customers will have to bear. I feel this is unfair not only to me, a small busisness man, but once again the American consumer. This bill gives the major oil companies the advantage over the little guy with all the extra cash flow from the collection of this tax they will have.

I also supply municipalities and fire departments organizations with gasoline and the way I read the bill these customers will have to pay the tax and apply for the refund, increasing the paperwork at the local level.

I hope you can correct this situation before it takes effect.

Sincerely,

William C. Pepper
President

JOBBER
AMOCO
PRODUCTS

WILSON GAS & OIL COMPANY

605 SOUTH MARKET STREET — P.O. BOX 1839 — LANCASTER, SOUTH CAROLINA 29720

July 8, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
US House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing in response to your request for comments concerning the inclusion of amendments to Section 1703 of the Tax Reform Act of 1986 which eliminates wholesale distributors from the list of those eligible to collect and remit the excise tax on gasoline.

Since 1919 Wilson Gas and Oil Company, established by my father and grandfather, has managed to survive and serve the people in our community. By working hard for low margins we have managed to compete with the large companies. If no change is made in Section 1703 and our suppliers reap the benefits of our loss our company will lose in this competitive battle since cash flow is the key to our survival. Our profit margin is not sufficient to pay interest on the financial loan required to pay tax on product before we have sold and collected for it. Credit lines are too costly when obtainable.

Please consider the proposal submitted by our national association the Petroleum Marketers Association of America (PMAA) which amends Section 1703 so that marketers would retain the right to remit the tax to the Treasury.

Thank you.

Sincerely yours

Elizabeth Wilson

Elizabeth Wilson, President

Phone: (205) 821-7138

Wilson Oil Company, Inc.
P. O. Box 2340
1525 Pumphrey Drive
Auburn, AL 36830

July 8, 1987

The Honorable Dan Rostenkowski
Chairman Ways and Means Committee
House of Representatives
Washington D.C. 20515

Dear Sir:

We want to make our position known to you concerning section 1703 of the 1986 Tax Reform Act. We would like to see this section amended so that small marketers such as us would retain the right to remit the tax to the treasury.

We certainly support steps to end excise tax evasion, but believe evasion can be eliminated wihtout adversely impacting the thousands of legitimate marketers such as us who have remitted all of the excise taxes that were due.

If congress implements this change in the way taxes are paid, it will cause serious cash flow problems for small marketers such as us. It will also create serious competitive imbalances between marketers and refiners. We are a small business and this kind of imbalance would be very adverse to us.

We would like to point out that PMAA has developed a proposal which will still allow collection of the excise tax as gasoline breaks bulk at their terminal thus leading to no lag time in the collection process over that provided under the new law.

We would like for you to give serious consideration to the proposal put forth by PMAA.

Sincerely,

H.E. Wilson
Wilson Oil Co., Inc.
H.E. Wilson President

WOLF BROS. INC.
GRAIN · FEED · SEED · FERTILIZER
FUEL OIL · GASOLINE · PAINT
1985 Highway 175
Richfield, Wisconsin 53076

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 RHOB
Washington, DC 20515

The Honorable Dan Rostenkowski:

This letter is to inform you of our opposition to The Technical Corrections Bill (HR 2636 and S 1350) specifically as it relates to the collection of Federal Excise Taxes on gasoline. We urge you to revise Section 1703 of the Tax Reform Act of 1986 because:

Section 1703 was drafted hastily, without an assessment of the competitive imbalances it creates;

Marketers suffer a loss of cash flow while their suppliers, with whom they compete, do not, leaving marketers at a competitive disadvantage in the marketplace;

Section 1703 needs to be revised if these serious competitive imbalances are to be remedied; and

The national trade association representing petroleum marketers, PMAA, has developed a proposal that will resolve the competitive problems created by Section 1703 with the least possible revenue impact while at the same time preserving to the greatest extent possible the protections against tax evasion established in Section 1703.

Areas of concern in relation to the proposed changes include:

1. Fear that our membership will face shrinking working capital problems due to accelerated payment of the tax.
2. A desire that the companies collecting the tax, who are often not only our suppliers but also our competitors, don't gain any advantage from their position as the collector of these taxes.
3. The technical problems this change must address will be difficult to resolve satisfactorily. These include:
    a) How will the different tax rate applicable to ethanol/gasoline blends be collected and accounted for?

WOLF BROS. INC.
GRAIN - FEED - SEED - FERTILIZER
FUEL OIL - GASOLINE - [redacted]
1985 Highway 175
Richfield, Wisconsin 53076

b) Will the tax be based on gross or net gallons?

c) Will any allowance be given for shrinkage?

4. The speed up in transfer of these gasoline excise tax funds to our suppliers will result in a diminished banking relationship between our members and their local banks. Money normally used by local community banks for loans and other purposes will be going to larger banks in New York and Houston, thus depriving Illinois Banks of accessible funds.

5. Changing of this tax system will adversely affect the petroleum marketer by increasing the purchase price and inventory cost by at least 15 percent, figured on the average cost of 60 cent per gallon.

6. If this federal excise tax on gasoline is to be paid to the refinery/supplier, it is of utmost importance that the rule include a provision that the tax invoice the jobber will receive allows ten days for payment.

7. Use the various State's Department of Revenue as an aid for auditing the Federal Excise Tax on gasoline. According to our experience, the various states do an excellent job in auditing state motor fuel taxes.

8. Why not allow a refinery to sell to the licensed distributor tax free, and the licensed distributor will be allowed to resell only on a tax paid basis. This would stop daisy chains which are notorious for avoiding federal excise taxes.

9. Special fuels taxes will still have to be collected and submitted by the distributor on a monthly basis so not much paper work will be eliminated.

Yours truly
Kenneth W. Wolf, Treas.
Wolf Bros. Fuel, Inc.

WORSLEY
COMPANIES

WORSLEY COMPANIES, INC.
10 Cardinal Dr. • P. O. Box 3227 • Wilmington, N.C. 28406 • (919) 395-5300

June 26, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I am writing to express my opposition to Section 1703 of last year's tax bill which requires that as of January 1, 1988 petroleum marketers will lose the right to collect and remit gasoline excise taxes.

Although I recognize that this was based upon Congress' goal to reduce tax evasion, I believe this could be accomplished in other ways rather than imposing this severe penalty on petroleum marketers.

Petroleum marketing is a very competitive business and the loss of cash flow involved in collecting and remitting taxes will put marketers at a competitive disadvantage in the market place. Based upon our most current information, our staff has calculated that the change to the new method would cost our companies in excess of $100,000 per year! More importantly, since the major oil companies would continue to be entitled to collect and remit taxes, they would have even more of a competitive advantage over independent marketers. Retail outlets owned by the major oil companies would have a built-in profit margin advantage.

The serious cash flow problems and competitive imbalances which would be created by this change would have a major impact on the profitability and even survival of petroleum marketers. Although tax evasion is a problem which needs to be addressed and remedied, the tax collection process is an ill-advised means of attaining this goal because in the process, the price tag paid by independent marketers only accentuates the competitive disadvantage in competing with the major oil companies, all of which will ultimately work to consumers' disadvantage. The **Petroleum** Marketers Association of America has proposed an **amendment which helps address the tax evasion problem while avoiding the imposition of financial hardship on** anyone.

I urge to you consider the Petroleum Marketers Association of America's proposal and revoke the Section 1073 provision. Thank you for your consideration in this matter.

Sincerely,

Roger ~~D.~~ Teague, ~~CPA~~
Controller

Section 1706

July 8, 1987
PO Box 7482
Rockford, Il. 61126

The Honorable Dan Rostenkowski
2111 Rayburn House Office Building
Washington D.C. 20515

Dear Congressman Rostenkowski

Section 1706 of TRA '86 is having a devastating effect on the business of independent consultants and contractors in the United States. It singles out a highly productive segment of industry for discriminatory and unfair treatment. It creates a decrease in productivity and increase in costs to clients, including government clients.

Independent consulting should be recognized as a legitimate form of business. Independent consultants provide highly skilled technical services to solve particular business problems for clients.

The "20 questions" or "common law rules" are ambiguous and the fact that the IRS has broad interpretative powers with little or no legislative review creates a climate of fear rather than productivity for consultants and clients. This is why Congress created Section 530 in 1978 and Section 1706 now reverses that intent for technical consultants.

Section 1706 has already caused many small business failures and threatens thousands more. It also poses a future threat in that it sets a dangerous precedent that may affect other industries as well.

Section 1706 prevents a small consulting business from subcontracting to another - which is an industry standard method by which a small consulting firm begins to grow into a larger one. Section 1706 favors and benefits larger consulting firms while destroying smaller ones. This is not an issue of taxes but rather an issue of fair competition in the marketplace.

Congressman Rostenkowski won't you help put an end to this anti-competitive conduct and these small business failures by cosponsoring H.R. 792 and 1240?

Respectfully,

Randy Garrett

Randy Garrett

Charles C. Brown, Pres.
Idea Research, Inc.
81-83 Grand St., Suite 2
Jersey City, NJ 07302

The Honorable Dan Rosentkowski
House of Representatives
House Office Building
Washington, D.C. 20515

July 10, 1987

Dear Congressman Rostenkowski:

I have been an independent computer consultant for more than 10 years during which time most of my work has been obtained by sub-contracting through a small consultant brokering firm. Although I never lacked for work throughout this period, thanks to section 1706 of the new tax law, I have been without a job since January of this year when I was informed that I would have to become an employee of the brokering firm to continue in in my consulting position. The firm offered none of the usual benefits associated with employment and so I refused to accept their ultimatum. This has meant the loss of $35,000 of income.

Before becoming an independent consultant, I spent 12 years as an employee working separately for 2 major companies. For that effort I received not a penny in pension rights. One of the principal advantages of being an independent contractor was that I could structure my own pension plan to provide for my retirement. Now, at age 56, at a time when most companies are wary of hiring independents, unless I can find freelance work, my carefully laid retirement plans go out-the-window.

As a citizen I am particularly concerned over the manner in which section 1706 was eased into the tax code. I had no opportunity to comment on or object to this provision, even though it meant the virtual destruction of my business. It is especially disturbing that a particular group of professionals should be singled out for unfavorable treatment. In what way can this law help promote the American entreprenurial tradition, much less a citizen's right to representation and free trade?

I therefore fully support House bill 1240 which would repeal section 1706. I also support House bill 792 introduced to delay implementation of section 1706 until such time as it can be fully and openly discussed, and hopefully repealed.

I request your support and response in this matter.

Yours, truly,
Charles C. Brown
Charles C. Brown

MAGA
Mexican American
Grocers Association

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July 23, 1987

Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515-6348

Dear Congressman Rostenkowski:

We wish to bring to your attention our endorsement of Bill H.R.1240 to repeal Section 1706 of the new tax law.

Our organization, the Mexican American Grocers Association (MAGA), fully supports all efforts that have been undertaken by self-employed technical personnel and their respective societies and associations, to repeal Section 1706 of the new tax law which in our opinion, has unjustly singled out their profession.

As Chairman of the House Ways & Means Committee (HWMC), we urge that you communicate our position on this issue to other members of your committee and to endorse passage of bill H.R.1240.

Sincerely,

Steven A Soto
Steven A. Soto
President & Chief Executive Officer

405 North San Fernando Road • Los Angeles, California 90031 • (213) 227-1565

The Society of Hispanic Professional Engineers
5400 E. Olympic Blvd. Suite 120 · Los Angeles, CA 90022
Tel: (213) 725-3970/3988

July 21, 1987

Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
1102 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515-6348

Dear Congressman Rostenkowski:

We wish to bring to your attention our endorsement of H.R.1240 to repeal Section 1706 of the new tax law.

Our organization, the Society of Hispanic Professional Engineers (SHPE), is the largest Hispanic engineering organization in the country with a combined membership of over 6,000 individuals from the various technical professions. In keeping with our policy to promote the well being and professional growth of our membership, we urge your committee and its members to repeal Section 1706 of the new tax law which in our opinion has unfairly singled out our profession.

Should you or any member of the House Ways & Means Committee (HWMC) require any further information regarding our organization's endorsement of H.R.1240, please feel free to contact us at our national headquarters at the address shown above.

We look forward to a favorable response from you.

Sincerely,

Hector A. Castillo
Hector A. Castillo
National President

ANDREW J. VENTRE, Ph.D.
PO Box 5393
Huntsville, AL 35814

205-852-9317

27 July 1987

Congressman Dan Rostenkowski
Chairman, House Ways & Means Committee
Rayburn Office Building
Washington, D.C. 20510

Dear Congressman Rostenkowski:

The Tax Reform Act of 1986 passed by Congress last year contains a provision (Section 1706) which is insidious, harmful, discriminatory and biased against engineers and other professionals who have been earning their income as consultants.

Congress enacted Section 1706 without holding hearings on its potential impact on the consulting community. As a result, many consultants have been nearly put out of business. Their right to enter into contracts with others for their services has been seriously impaired. Potential clients are now hesitant to engage consultants for fear of breaking the law or running afoul of IRS regulations. Furthermore, Section 1706 has tilted the competitive balance in the technical consulting marketplace, always precarious at best, in favor of a handful of large service firms at the expense of thousands of independent entrepreneurs and small businessmen.

It is my understanding that there are three bills presently before the House Ways and Means Committee which would either repeal or delay Section 1706 of the Tax Reform Act. These are HR 1706 (for repeal) sponsored by Representative George Hochbreuckner of New York; HR 1240 (for repeal) sponsored by Representative Joseph DioGuardi also of New York; and HR 792, sponsored by Representative Judd Gregg of New Hampshire (with 87 co-sponsors) which would delay the effective date of Section 1706 for two years. The last bill, while being a step in the right direction, will only prolong the misconceptions which presently abound in the technical and industrial communities concerning the tax code. I therefore urge you to lend your considerable support to the repeal of Section 1706 and vote for either HR 1706 or HR 1240.

I urge you to actively support and vote for rescission of this nefarious tax code provision before any long term harm is done to consulting engineers and others. Thank you for your attention.

Yours very truly,

Andrew J. Ventre

Andrew J. Ventre, Ph.D.

Title XVIII
Section 1803

ARTHUR ANDERSEN & Co.

OFFICE OF FEDERAL SERVICES

1666 K STREET, N.W.
WASHINGTON, D.C. 20006
WRITER'S DIRECT DIAL NUMBER

(202) 862-3230

July 17, 1987

The Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
1102 Longworth House Office Building
United States House of Representatives
Washington, D.C. 20515

Re: Technical Corrections Act of 1987, H.R. 2636

Dear Chairman Rostenkowski:

As a firm, Arthur Andersen & Co. provides tax advice to several hundred banks in the United States. Our comments herein are our own, not on behalf of particular clients, although many of our clients are affected by the proposed changes.

We are concerned with the application of the change to Section 1281 of the Code dealing with the accrual of discount on certain short-term obligations, as described in Section 118(c) of H.R. 2636; and as explained on Pages 282 and 283 of the "Description of the Technical Corrections Act of 1987," as prepared by the staff of the Joint Committee on Taxation. The technical correction, as proposed, would change the effective date of the change to Section 1281 from September 27, 1985, to December 31, 1985.

Our experience in dealing with many of our banking clients is that the original effective date requires that a considerable amount of effort and cost be expended to determine the amounts of income to be reported in amended 1985 tax returns. For this reason, the change in the effective date is welcomed.

A better solution to the confusion created by this change in the tax law, that was largely overlooked in terms of its application by many affected banks, would be to provide banks with the option of using an effective date of January 1, 1987, to conform with the change to the accrual method of accounting that will be required for many banks. This could be accomplished by allowing an election as to the effective date to be filed with an amended return, if necessary, for 1986; or, in the alternative, included in the reporting required for an overall change of accounting method in 1987. This would likely have minimal revenue effect. It would also decrease the problems upon examination of returns since there would be ample time to inform the industry of the change.

We appreciate the opportunity to submit our views on this matter and will be pleased to answer any questions concerning this issue.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Howard L. Wright
Howard L. Wright
Director of Bank Taxation

THE National Bank OF CORRY

139 N. CENTER STREET
ESTABLISHED 1895
CORRY, PENNSYLVANIA
16407

August 24, 1987

The Honorable Dan Rostenkowski
Chairman-House Ways and Means Committee
1101 Gongsworth HOB
Washington, D. C. 20515

Dear Congressman Rostenkowski:

In the course of the tax reform of the last few years, small cash basis banks have been burdened with mandatory accrual of interest rules found in Section 1281 of the Internal Revenue Code.

We at The National Bank of Corry were happy to see that Congress has attempted to address the problems which have arisen with the passage of Section 1281 in its 1987 Technical Corrections. However, we feel that it is imperative to point out that the action taken in the Technical Corrections is not enough to alleviate the substantial remaining burdens of the present law.

As we pointed out in our last letter dated June 29, 1987, the requirements of this provision are virtually impossi[illegible] comply with. Since the sought after figures were not required to be kept in the past, they do not exist now so as to allow for their after-the fact calculation today. By continuing to give section 1281 an effective date that is retrospective in nature, Congress will force small cash basis banks such as The National Bank of Corry to undertake extremely costly efforts to comply with the law without any reasonalble expectation of being able to actually arrive at the numbers upon which the tax will be based.

We would like to point out that The National Bank of Corry still generally opposes the imposition of this accrual rule on a cash basis taxpayer such as the Bank. We are a family-owned business beset by the already heavy compliance and tax burdens borne by Banks. However, if Congress does not see fit to abolish the provision in its entirety, we would ask that you consider leading Congress to arriving at reporting requirements that allow the nation's small cash basis banks to accurately and fairly comply with the law on a prospective basis.

a copy of our previous letter is enclosed herewith.

Thank you again for your time and attention. We appreciate you effort in this matter and hope that you will help provide the necessary leadership in addressing and correcting the problems arising from Section 1281.

Very truly yours,

Clifford J. Buesink
Chairman of the Board

BEST AVAILABLE COPY

COPY

June 29, 1987

The tax reforms of recent years, as you know, have called upon members of the banking community to make many changes in their accounting practices and taxation which have burdened the members of the industry dramatically.

In light of these numerous changes, we must express our sincere concern and great reservation with regard to a technical correction found in the 1986 Tax Reform Act that now requires small, hometown cash basis banks [illegible]h as the National Bank of Corry to include interest on certain short term obligations retroactive to September 27, 1985.

Our concern stems from the burdensome technical requirements of the law, making compliance virtually impossible. Furthermore, the financial burden brought about by the taxes, interest, and penalties associated with the law's retroactive treatment is quite troublesome for an industry that is struggling for profitability.

We have enclosed a Congressional Correspondence, dated April 8, 1987, which outlines our position in more technical terms.

We appreciate your time and consideration of this matter, and hope that you will reconsider the burdensome effect of the present law.

Yours very truly,

Enclosure

COPY

BEST AVAILABLE COPY

THE National Bank OF CORRY
ESTABLISHED 1892
CORRY, PENNSYLVANIA
16407

H. MARTIN KEPPEL, PRESIDENT

July 6, 1987

The Honorable Robert Packwood
Ranking Minority Leader
Senate Finance Committee
G-08 Dirksen SOB
Washington, D. C. 20510

Dear Congressman Packwood:

The tax reforms of recent years, as you know, have called upon members of the banking community to make many changes in their accounting practices and taxation which have burdened the members of the industry dramatically.

In light of these numerous changes, we must express our sincere concern and great reservation with regard to a technical correction found in the 1986 Tax Reform Act that now requires small, hometown cash basis banks, such as The National Bank of Corry, to include interest on certain short term obligations retroactive to September 27, 1985.

Our concern stems from the burdensome technical requirements of the law, making compliance virtually impossible. Furthermore, the financial burden brought about by the taxes, interest, and penalties associated with the law's retroactive treatment is quite troublesome for an industry that is struggling for profitability.

We have enclosed a Congressional Correspondence, dated April 8, 1987, which outlines our position in more technical terms.

We appreciate your time and consideration of this matter, and hope that you will reconsider the burdensome effect of the present law.

Yours very truly,

THE NATIONAL BANK OF CORRY

H. Martin Keppel

H. Martin Keppel
President

CONGRESSIONAL CORRESPONDENCE

DAUB SEEKS CLARIFICATION OF TECHNICAL CORRECTION IN 1986 ACT.

Date: April 8, 1987

Mr. Dan Rostenkowski, Chairman Ways and Means Committee
2111 Rayburn HOB
Washington, D.C. 20515

Re: Cash Basis Bank Problem

Dear Mr. Chairman:

I have attached a memo which details a recent problem that has developed in the banking industry, particularly small banks still on the cash method of accounting. The technical correction title to the 1986 Tax Reform Act, clearly did not intend the result which has come to follow.

At this point I would only like to inform you of the problem, but I would like some kind of position statement from the Committee to indicate the intent of the rule and eventually a technical correction should be included in any bill we pass.

With best wishes, I remain

Sincerely,

Hal Daub Member of Congress

cc: Ways & Means Committee Members

SUMMARY

Recently, a major concern to banks using the cash basis of accounting has developed. The recently identified rule hits banks with loans maturing in a year or less (e.g. farm loans) particularly hard.

A more technical letter explaining the problem is attached, but it is briefly outlined below. The 1984 Act had a provision to tax interest earned on discounted paper (e.g. T-bills) held by cash basis banks on an accrual basis (Section 1281(a)(1)). The committee reports accompanying the DRA '84 indicate that the primary purpose of the change was to discourage the leveraged acquisition of Treasury bills and other discounted obligations. Thus, it is doubtful as to whether anyone ever intended for the provision to apply to loans made in the ordinary course of a trade or business.

However, the technical corrections to the 1984 Act (passed in the 1986 Act) included a provision in the same code section which requires cash basis banks to recognize any other interest income on ANY OBLIGATION of less than 1 year (Section 1281(a)(2). This rule applies to obligations acquired after 9/27/85 and is particulary harsh, and probably unintended for these reasons:

o NO MATCHING OF INCOME AND EXPENSES This rule requires the recognition of interest income for all obligations of less than 1 year. For many small banks this is effectively their entire portfolio (e.g. farm communities) but permits only limited recognition of "net direct interest expenses", a very small amount.

o MEANINGLESS EXCEPTION TO "SMALL" BANKS The 1986 Act includes a provision which exempts firms with less than $5 million in annual gross receipts from changing to the accrual basis. The rule above seems to undermine this exception for cash basis banks since most will want to change to an accrual basis of accounting if their loan portfolio is largely short term loans.

o UNFAIRNESS AMPLIFIED BY RATE STRUCTURE AND DEFERRAL RULES The 1986 Act requires all businesses with more than $5 million in gross receipts to change to the accrual method of accounting. But these banks will receive a 4-year spread of the deferral and at the new LOWER rates. While the cash basis banks affected by THIS rule must recognize a large part of their INCOME (but not their expenses) in the FIRST year the rule applies (1985), with no relief from the bunching of income, and at the old, higher rates in effect then.

o CHANGE IN ACCOUNTING METHOD COMES TOO LATE Most of these cash basis banks will elect to change their method of accounting after this year because it will allow them to accrue their current expenses against their current income. But this will not happen until at least two years after a lot of income will have already been accrued (1985- 87). Thus, in later years after electing the accrual method (1987+), a net loss will result in most cases from the additional accrual of expenses. When an election is made to make a change in accounting method the net loss has to be spread out over 6 years, which results in an even bigger hardship because these banks now have to wait 6 years to realize their losses.

o ACCOUNTING PROBLEMS We are not aware of a single bank which has filed their returns correctly since this law took effect on 9/27/85. In fact, it is virtually impossible to go back and amend these incorrect returns because banks do not categorize their loans according to the definition of a "short term obligation" in the code. Administratively, these cash basis banks will not be able to pay these costs, much less the additional tax.

o PENALTIES AND INTEREST It is believed that this law could increase taxes for some banks by 50% or more. The result is extensive penalties and interest charges dating back to 1985. Accounting firms only identified this problem 2-3 weeks ago and are now nervous as to how this year's returns should be filed, since they too are subject to penalties. Generally, these firms are advising clients to amend their prior year's returns, if possible, and to extend their 1986 returns until they can gather the necessary information, or a solution to the problem is found.

o IMPOSSIBILITY OF COMPLIANCE Section 1281(a)(1) was enacted in the 1984 Act and required the accrual of income from discounted paper (e.g. T-bills). The technical corrections to the 1986 Act (enacted 9/18/86) required interest on ANY obligation less than 1 year to maturity and acquired after 9/27/85 to be included in income. Because the technical correction was enacted AFTER virtually all 1985 returns were filed there is no way that these banks could comply with the new rule. Still, interest (and perhaps penalties) continue to accumulate on the tax owed.

SOLUTIONS

Obviously, there was some kind of "Wall Street" paper out there that was intended to be taxed under the 1986 technical correction which imposed a tax on the interest income from "any obligation", as opposed to only discounted paper. However, no one we have spoken to believes that the correction was intended to include "loans made to customers in the ordinary course of business" in the case of banks.

Thus, section 1281(a)(2) should include language which would exclude these loans from being accrued. We would like your support to make such a technical correction in the future.

This is a matter of some urgency to those filing returns this year. There should be some king of statement included in the "Blue Book" which would allow filers to file without including these loans in income and would waive penalties and interest charges.

If you agree with these proposals please call Mark Mullet (x51364) or Jim Clark (x54021) and inform them. We intend to contact both the Treasury Department and the Finance Committee in the Senate.

Section 1807

Proposed Technical Correction to Section 1807(a)(7) of
the Tax Reform Act of 1986

RE: Asbestos Related Injuries Fund

A technical correction to Section 1807(a)(7) of the Tax Reform Act of 1986 is proposed. That section permits a company in a Chapter 11 bankruptcy reorganization to utilize a trust to fund its asbestos liabilities. As a matter of fairness, that section should be amended to permit Eagle-Picher Industries, Inc., a company not in Chapter 11, to be accorded similar treatment.

Eagle-Picher is a Cincinnati-based diversified manufacturer of industrial products with operations in 33 states. The company has annual sales of approximately $650 million per year and employs about 8,000 people.

Prior to April 1972, Eagle-Picher manufactured insulating materials containing asbestos. Individuals allegedly suffering the symptoms of asbestos-related ailments have been filing claims against the Company for more than twenty years. Because of the long period of time between exposure to asbestos and the appearance of symptoms, it is expected that additional claims will be filed for several more years. Many of the claimants are individuals who worked in shipyards constructing vessels for the U.S. Government during World War II and the Korean conflict. Government contracts required the use of asbestos-containing materials by the contractors whose employees worked in the shipyards.

Eagle-Picher has diligently provided funds to make payments to claimants who have been injured by exposure to asbestos-containing insulation products. Providing for these claims has placed a significant financial drain on the company's resources. In recent years, the number of claims has increased dramatically. Because of the increased number of claims being filed against the Company and the related costs of litigation and settlements, additional funds will be required.

To provide assurances to the public that a fund will be available to make payments to harmed individuals, the Company desires to establish a trust fund for the benefit of present and future claimants. Any payments to such fund would be for the exclusive benefit of asbestos claimants and could not be returned to the Company. Eagle-Picher would be permitted a current tax deduction at the time of making non-refundable payments to such a self-administered trust fund.

As in Section 1807(a)(7)(C) of the Tax Reform Act of 1986, the income of the fund would be taxed at a 15% rate. The Company, Eagle-Picher, would be liable for the tax so that taxes would not diminish or reduce amounts available for claimants, and the tax would be deductible by the Company. The fund and any earnings of the fund could be used only to resolve and satisfy claims. Any amounts remaining in the fund after the last claim has been settled would become the property of the U.S. Government.

As stated above, the treatment accorded by Section 1807(a)(7) of the Tax Reform Act of 1986 is available to a former asbestos manufacturer that is in Chapter 11 bankruptcy. Like the company in a Chapter 11 bankruptcy reorganization, Eagle-Picher is obligated to compensate meritorious claimants for asbestos-related injuries. The company in Chapter 11, however, may use a trust as provided by Section 1807(a)(7) to fund its asbestos-related liabilities. There appears to be no reason to provide a more favorable rule for a company under Chapter 11 than for one of its solvent competitors. Accordingly, it is requested that the proposed technical correction be made to section 1807(a)(7) as part of the technical corrections bill, H.R. 2636, or any other bill by which technical corrections to the 1986 Act are made.

Suggested language for the proposed technical correction is attached.

Suggested language for a Proposed Technical Correction to Section 1807(a)(7) of the Tax Reform Act of 1986

(E) SPECIAL RULE FOR A FORMER MANUFACTURER OF ASBESTOS-CONTAINING INSULATION PRODUCTS.- In the case of any settlement fund which is established to resolve and satisfy claims related to the use of or exposure to asbestos-containing insulation products formerly manufactured by a corporation in Joplin, Missouri, which completely discontinued manufacturing such products by April 1972 -

(i) any portion of such fund which meets the requirements of subparagraphs (D) and (E) of section 468B(d)(2) of the Internal Revenue Code of 1954 (as amended by this paragraph), and with respect to which an election is made under subparagraph (F) thereof, shall be treated as a designated settlement fund for purposes of section 468B of such code, and any payment made to such fund shall be considered a qualified payment under section 468B(d)(1) irrespective of whether such payment is made pursuant to a court order.

(ii) such corporation (or any successor thereof) shall be liable for the tax imposed by section 468B of such Code on such fund (and the fund shall not be liable for such tax), such tax shall be deductible by the corporation, and the rate of tax under section 468B of such Code for any taxable year shall be equal to 15 percent.

(iii) any amounts remaining in the fund after the last claim has been settled will become the property of the U.S. Government.

Submitted by: James G. Baird, Vice President
Eagle-Picher Industries, Inc.
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August 18, 1987

Dear Sirs:

I am writing to strongly urge that two completely nonsubstantive provisions be added to H.R. 2636 and S. 1350, the Technical Corrections Bill of 1986. In two cases, the Tax Reform Act of 1986 (the "1986 Act") made permanent substantive changes to the tax law, but failed to codify these changes in law by making them part of the Internal Revenue Code. I urge that the Technical Corrections Bill amend the Code to incorporate these changes in law, which are presently in effect, in order that taxpayers and their advisors may be made aware of these changes much more readily than if they remained uncodified.

1. Section 1807(a)(7)(D) of the 1986 Act provides, for accounts or funds established after August 16, 1986:

> Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. If contributions to such an account or fund are not deductible, then the account or fund shall be taxed as a grantor trust.

This provision reverses at least one published revenue ruling. See the May 13, 1987, Blue Book explaining the technical corrections provisions contained in the 1986 Act, at p. 42. Moreover, this provision appears to result in far-reaching changes in the treatment of escrow funds. For example, suppose a buyer of property puts a portion of the purchase price into escrow at the closing, with the seller to receive the escrow plus all earnings thereon when certain contingencies are resolved. It now appears that (1) all earnings on the escrow are taxed currently to the buyer (the "grantor" of the escrow fund), (2) the entire balance in the escrow fund, including earnings, is to be treated by both parties as deferred additional purchase price, and (3) the imputed interest rules of Code §§ 1271-1275 will frequently apply to this deferred purchase price, with the earnings on the escrow being treated as "contingent payments" under those rules.

While the wisdom of this result is debatable, the most important thing is that taxpayers know what the rules are. This provision will be a trap for the unwary if it is not made part of the Code itself.

2. Section 44(b)(3)(A) of the Tax Reform Act of 1984 (the "1984 Act"), as amended by Section 1803(b)(2) of the 1986 Act, provides in substance that (a) notwithstanding any other provision of law, no interest is deductible before the period to which it is properly allocable, and (b) section 483 of the Code "shall be treated as including provisions similar to the provisions of section 1274(b)(3) of such Code". These provisions had originally been adopted as transition rules in the 1984 Act, and only applied before January 1, 1985; the 1986 Act deleted the references to January 1, 1985, giving these provisions permanent effect.

These provisions are clearly important enough to be in the Code.

Sincerely,

Michael L. Schler

Section 1808

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July 17, 1987

Robert J. Leonard, Esq.
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Committee on Ways & Means
U. S. House of Representatives
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Dear Rob:

Pursuant to your recent announcement, this letter is submitted to support a technical correction for inclusion in H.R. 2636. Specifically it concerns a proposed Technical Correction to Section 108 of the Tax Reform Act of 1984 as Amended by Section 1808(d) of the Tax Reform Act of 1986.

Summary

Recently, the Service has begun attacking straddles in stock options traded over regulated domestic exchanges which occurred prior to the enactment of the Tax Reform Act of 1984. (That Act brought such options under the statutory straddle rules first enacted in the Economic Recovery Tax Act of 1981.) The proposed technical correction would extend the coverage of section 108 of the Tax Reform Act of 1984 to such stock options, thereby preventing the Service from whipsawing investors in such options by disallowing the losses reported from each straddle while at the same time taxing them on their reported gains from the straddle. The proposed technical correction would also extend the irrebuttable trade or business presumption of section 108(b) applicable to commodities dealers' commodities straddles to options dealers' stock option straddles. The proposed technical correction would have no impact on the controversial issue of the degree of profit motive required to be demonstrated by straddle investors for recognition of their straddle losses.

Background

Prior to the Economic Recovery Tax Act of 1981 (hereinafter "ERTA"), numerous issues with respect to the taxation of straddles were unclear. The Internal Revenue Service had ruled in Rev. Rul. 77-185, 1977-1 C.B. 48, that no loss could be recognized on the disposition of a leg of a silver futures straddle until all of the legs of the straddle were disposed of and, in any event, even the net loss arising from the straddle could not be allowed because the taxpayer had "no reasonable expectation of deriving an economic profit from the transaction." In Smith v. Commissioner, 78 T.C. 350 (1982), the Service litigated the issues of Rev. Rul. 77-185 in the context of silver futures transactions entered into by customers of Merrill Lynch conducted on the COMEX. In Smith, the Tax Court rules that, contrary to Rev. Rul. 77-185, losses could be recognized on the disposition of a leg of a silver futures straddle even though other legs had not yet been disposed of. The Tax Court, however, concluded that the taxpayers therein did not have the requisite profit motive to deduct the recognized losses.

The Service was displeased with the ruling in Smith and moved for reconsideration of the case on April 2, 1982. The

Service again requested the Court to rule that losses could not be recognized until all legs of a straddle were disposed of. In its motion, the Service warned that if the Tax Court did not change its position, the IRS "intends . . . to follow the logical consequences of the . . . opinion and seek the disallowance of the tax straddle losses, coupled with the recognition of tax straddle gains." Despite the Service's threat to whipsaw taxpayers, the motion for reconsideration was denied.

At the same time it was litigating the Smith case, the Service commenced litigation projects with respect to straddle transactions in other commodity futures, silver futures traded outside the United States, and options on U.S. Treasury Bills. In so doing, the Service did not limit its attack on straddles to ordinary investors, but broadened its attack to include dealer transactions as well.

In title V of ERTA, Congress provided statutory rules to prospectively govern the taxation of certain straddles. The straddles covered by ERTA included straddles in futures contracts, but did not include straddles in stock options of the kind ordinarily traded on domestic options exchanges. (See IRC §1092(d)(2)(B), as added by ERTA.) The rationale for such exclusion apparently was that straddles in domestic stock options could not be used to convert short-term capital gain to long-term capital gain and were thus less of a revenue concern. Conversion was impossible because domestic stock options would always expire prior to the long-term gain holding period. S. Rept. No. 97-144, 97th Cong., 1st Sess. 151 (1981).

In subtitle H of the Tax Reform Act of 1984 (hereinafter "TRA '84"), Congress repealed the exception of domestic stock options from the rules added by title V of ERTA. Henceforward, domestic stock options were generally governed by the loss deferral rules of IRC §1092 or, in the case of options dealers, by the mark-to-market rules of IRC §1256.

At the time TRA '84 was being considered, Congress became concerned with the huge backlog of pre-ERTA straddle cases which had accumulated in the Tax Court. In section 108 of TRA '84 Congress sought to provide some retroactive rules for the treatment of those straddles in order to speed the resolution of those cases. (H. Rept. No. 98-861, 98th Cong., 2d Sess. 917 (1984).) Those rules were as follows:

1. With minor exceptions, the fact that a position was held as part of a straddle would not be considered in determining whether there was gain or loss, the timing of such gain or loss, and the character of such gain or loss as short-term or long-term. TRA '84 §108(d). In light of this provision, the Treasury announced: "The closed and completed transaction argument [set forth in Rev. Rul. 77-185] will not be made regarding transactions subject to section 108 of the Act." Temp. Reg. §1.165-13T (A-9) (August 21, 1984).

2. To prevent the Service from disallowing losses but taxing the gains from a straddle transaction where the taxpayer was held not to have had the requisite profit motive (i.e., the whipsaw which the Service had threatened in its motion for reconsideration in Smith), the disallowed loss in such a case would be allowed as an offset to the gain reported at the time the remaining positions of the straddle were disposed of -- i.e., the "net loss" from all the straddle positions was allowed to the taxpayer. TRA '84 §108(c).

3. Commodity dealers were rebuttably presumed to have engaged in their straddle transactions in commodities with the requisite profit motive to deduct their losses at the time of recognition. TRA '84 §108(b).

The above rules were made applicable to any pre-1982 "straddle" which was not the subject of ERTA's rules. For this purpose, "straddle" was defined as that term was defined in IRC §1092(c) immediately after its enactment by ERTA. TRA '84 §108(e). Since a straddle in domestic stock options was not treated as a "straddle" by ERTA, straddles in domestic stock options were not affected by the above rules of TRA '84 §108. Temp. Treas. Reg. §1.165-13T(A-1) ("Straddles in certain listed stock options were not covered by ERTA and are not affected by this provision.")

Shortly after the enactment of TRA '84 §108, it became apparent that a rebuttable presumption for commodities dealers was of little help in quickly resolving their cases. Accordingly, in section 1808(d) of the Tax Reform Act of 1986 (hereinafter TRA '86), TRA '84 §108(b) was modified to make the commodities dealer presumption irrebuttable "because of the inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions when the taxpayer was in the trade or business of trading in commodities." H. Rept. No. 99-426, 99th Cong., 1st Sess. 910-911 (1985).

Recently, the Internal Revenue Service again broadened its attack on straddles to include an attack on pre-TRA '84 domestic stock option straddles -- particularly those entered into by options dealers (i.e., market makers registered with domestic options exchanges). It has done so, despite the fact that such straddles did not give rise to conversion of the character of income (i.e., from ordinary to capital or from short-term capital to long-term capital), and thus involved the least potential tax benefit, and despite the fact that substantial non-tax profits and losses are generated in stock options straddles (unlike certain other straddles where the potential for profit is small).

Reasons for Technical Correction

Investors and dealers who engaged in pre-TRA '84 domestic stock option straddles now face the same predicament formerly faced by investors and commodity dealers with respect to pre-ERTA straddles. The government, not constrained by TRA '84 §108, is once again threatening to raise its old arguments, which may include Rev. Rul. 77-185's closed and completed transaction theory and the whipsaw of the taxpayer through the taxation of straddle gains coupled with the disallowance of straddle losses. This latter argument is even more dangerous to taxpayers who engaged in domestic stock options straddles than it was to taxpayers who engaged in pre-ERTA straddles. Most pre-ERTA straddles involved the element of conversion -- e.g., losses were claimed as short-term capital but gains were reported as long-term capital. If losses in pre-ERTA straddles were disallowed, the phantom gains on which the taxpayer would pay tax would be long-term capital gains. By contrast, since pre-TRA '84 domestic stock options straddles did not involve the element of conversion, if losses were disallowed, the phantom gains on which the taxpayer would pay tax would be short-term capital gains and the phantom tax would be higher.

As Congress recognized in TRA '84 §108, there is no policy reason for taxing large phantom gains in straddle transactions in which the taxpayer actually lost (or earned) comparatively little money, net. In addition, to tax such phantom gains would be to place individuals who traded over regulated domestic exchanges in a worse position than those who engaged in fictitious or sham straddle trades. (The latter individuals could not be forced to pay tax on sham gains.) There is no policy reason why the anti-whipsaw benefits of TRA '84 §108(c) should not also extend to pre-TRA '84 domestic stock option straddles and it can only be assumed that the previous failure of TRA '84 §108(c) to cover domestic stock option straddles was an unintentional oversight.

Secondly, like commodity dealers, options dealers engage in numerous straddle trades in the course of their business. Straddle trades enable options dealers to reduce their risk in making a market in each option. For example, if one investor desires to purchase a call in Company A November options with a strike price of 100 and if a different investor seeks to sell a call in Company A November options with a strike price of 105, no trade would occur unless the dealer takes the opposite side of each of the above trades. A straddle forming the opposite side of the investors' trades would enable both trades to be completed at a lower risk to the dealer than if the dealer assumed the other side of each trade at different times. It would be extremely difficult for a court to determine which, if any, option dealer option straddles were not entered into in the ordinary course of business or were not entered into for profit. In order to prevent the wasting of resources (both the taxpayers' and the government's) in litigating option dealer straddle cases, where it would be unlikely in any event that the government would prevail, the irrebuttable trade or business presumption of TRA '84 §108(b), as amended by TRA '86 §108(d), should be extended to options dealers.

It should again be noted that the proposed technical correction takes no position and has no effect the much-debated issue of the level of profit motive required for an investor to recognize losses in the case of straddles covered by TRA '84 §108. *See Glass v. Commissioner*, 87 T.C. 1087 (1986); *Miller v. Commissioner*, 84 T.C. 827 (1985), on appeal (10th Cir., Nov. 20, 1985); H. Rept. No. 98-861, 98th Cong., 2nd Sess. 917 (1984); H. Rept. No. 99-426, 99th Cong., 1st Sess. 911 (1985); 132 Cong. Rec. S13956 (daily ed. Sept. 27, 1986) (colloquy between Senators Dole and Packwood); 132 Cong. Rec. E3389, E3391 (daily ed. Oct. 2, 1986) (statement of Mr. Rostenkowski); Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation (Joint Committee on Taxation May 13, 1987) at 45; 133 Cong. Rec. S7696-S7697 (daily ed. June 5, 1987) (statement of Senator Dole).

Sincerely,

WILLIAMS & JENSEN, P.C.

Robert Glennon

Robert E. Glennon

Kermit L. Lilja
105 Broadview Place
Missoula, Montana 59803
July 16, 1987

House Ways & Means Committee
Room 1102
L.H.O.B.
Washington, D.C. 20515

Re: Technical Corrections to the 1986 Tax Act, Silver Straddles

Dear Sirs:

I would like to submit my comments, by way of background and recommendations, on the technical-corrections bill as it pertains to silver straddles transactions.

Background:

1) Reference is made to a quote from Judge Learned Hand: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasurey; there is not even a patriotic duty to increase one's taxes." Judge Learned Hand, U.S. Circuit Court.

2) The technical correction on Silver Straddles is up to eleven years retroactive.

3) The law was corrected to assist the IRS case which, it appears, the IRS had lost. The heavy-handedness, apparent in the attempt to change the court decision does not help congressional or IRS credibility.

4) Certainly, since the IRS recognized a suspected problem in 1975, the IRS and Congress had plenty of time to correct the legislation and, at that point in time, it would have been only two years retroactive.

Recommendations:

1) Technical corrections should never be retroactive more than three years (see number 4 above).

2) The cost for ineptness in writing legislation that needs to be corrected should not be passed on to taxpayers in the form of penalties and interest.

3) Technical correction in and of itself is an admission of omission or error, (not a fault of the taxpayer). As such, tax would be due and no interest charged. Errors of the taxpayer should still include both.

Sincerely,

Kermit L. Lilja, Taxpayer

Section 1825

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July 13, 1987

Mr. Robert J. Leonard
Chief Counsel
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1102 Longworth House Office Building
Washington, D.C. 20515

Dear Rob:

Enclosed are two memorandums dealing with the taxation of preneed trust income. The first memorandum dated April 27, describes preneed contracts and trust and income tax problems in general. The second memorandum dated July 6, describes a legislative proposal for dealing with the problem. Both memorandums are the products of the Coalition of Funeral and Cemetery Industry Representatives. The Coalition has been working on the problem for several months and we believe the prepared legislative solution is fair and workable. As you know, a portion of this problem was dealt with in the Tax Reform Act of 1986 in which Senator Long offered an amendment to the Senate Tax Bill which took care of the problem for insurance taxes in Section IRC Section 7702(e)(2)(C). We hope that the Committee will be able to address this issue in the Technical Corrections Act of 1987. If I can provide you with further information, please give me a call

Sincerely,

BRACEWELL & PATTERSON

Michael L. Pate

MEMORANDUM

FROM: Funeral and Cemetery Industry Coalition

RE: Proposal Relating to Taxation of Preneed Trust Income

DATE: April 27, 1987

The Coalition

The Funeral and Cemetery Industry Coalition consists of representatives of national funeral director and cemetery trade associations, several state and local trade associations, several large publicly and privately held companies in both industries, and members of the investment community. The Coalition was formed to propose changes in order to clarify the taxation of earnings on preneed funeral and burial arrangements.

Background

The Tax Reform Act of 1986 amendment to Code § 673 and conflicting IRS policies have confused the taxation of income earned by preneed trusts.

In a "preneed contract", a consumer agrees to make payments to a funeral home, cemetery or other "seller", and the seller agrees to provide specifically described funeral or burial merchandise or services at the consumer's death.

The average contract price is between $2,000 and $4,000. Most consumers are elderly, are of modest means, and live on the average of 13 years after the preneed contract is made.

Preneed contracts are strictly regulated under 47 different state laws. All state laws require the seller to deposit most or all of the consumer's payments into a segregated fund, usually a trust, as security for the seller's performance of the contract.

The state laws vary in many ways regarding this segregated fund (a "preneed trust"). Some state laws allow some or all trust income to be distributed as earned to the seller, while others require trust income to be accumulated inside the trust. Under some state laws, the consumer has the right to cancel his preneed contract, while other state laws prohibit or limit cancellation.

When a consumer cancels his preneed contract, all applicable state laws require that most or all of his deposited payments be returned to him. However, some state laws give accumulated trust income to the consumer, some give it to the seller, and some divide it between them.

In some instances a separate preneed trust is established for each preneed contract, but many preneed contracts are administered under master trust agreements. Several master trusts contain over 10,000 accounts for contracts, sold by several different sellers.

Consumers payments deposited into preneed trusts are not taxed to the seller as received, because the seller has no access to them. However, these payments are taxed to the seller as ordinary income when the seller provides the prearranged service or merchandise.

While the tax consequences of payments received from the consumer are clear, legislative action is needed to resolve the taxation of income earned by preneed trusts.

Present Problem

Since the 1954 Code, preneed trusts have been taxed under Subchapter J, with particular reference to the "grantor trust" rules of Code § 671 through § 678. However, in some instances the seller has been taxed as the owner of the trust, in other instances the consumer has been taxed as owner, and in still other instances each trust has been taxed as a separate taxable entity.

When trusts are taxed as separate taxable entities, a separate tax return must be filed for each trust with taxable income. Since annual net income from a $2,000 to $4,000 trust is only slightly more than the trust's $100 exemption, any resulting tax is quite small. The administrative expense of preparing these returns (including a separate payment check for each return) and the IRS's expense of processing them, far exceed any revenue raised. However, the IRS has, in some instances, refused to allow master trusts to file composite returns for their constituent trusts.

There has been and is substantial controversy between the IRS and various sellers, and even among different sellers, about who is the proper taxpayer and when taxes are due. The IRS has taken inconsistent positions, and there is confusion throughout the industry. Much of the conflict can be blamed on the myriad variations in state laws. Nevertheless, substantially identical transactions are now taxed inconsistently.

The Tax Reform Act of 1986 amendment to Code § 673 (which eliminated Clifford trusts and other income shifting arrangements used by individuals) has aggravated the uncertainty. In virtually every instance, both the seller and the consumer arguably have a 5% reversionary interest in a preneed trust.

A preneed contract is a business transaction. The consumer intends that his payments pay for his prearranged service or merchandise. He does not intend to fund a preneed trust as an income shifting device (as in most grantor trust situations).

Trust income should be taxed to the recipient. Often it is easy to determine the recipient, and he should be taxed. But in many instances it is impossible to predict whether the seller or the consumer will eventually receive accumulated trust income, and taxation should be deferred until the recipient is identified.

Statutory Proposal

Code § 673 should be clarified to provide that preneed trust income is taxed to the seller, as grantor, where trust income either is distributed to the seller as earned or is accumulated for future distribution to the seller upon the consumer's cancellation of the preneed arrangement. In all other instances, taxation of preneed trust income should be deferred until it is actually distributed. When the accumulated income is eventually distributed to the consumer (upon cancellation) or to the seller (at death), the distribution should be taxed to the recipient.

Preneed trusts should file information returns regarding the accumulation and distribution of income. Master trusts should be authorized to file composite returns which include information regarding their constituent trusts.

Insurance Compared

The proposed change will bring preneed trust taxation into harmony with the taxation of life insurance purchased to pay funeral and burial expenses. Consumer premium payments are not taxed to the insurance company to the extent deposited into its reserve account. Income earned by the reserve account is not taxed to the consumer unless actually paid to him.

The Tax Reform Act of 1986 amended Code § 7702(a)(2)(C) to make certain that income allocated to funeral and burial insurance (increasing surrender value) was not taxed to the consumer unless distributed to him during his lifetime, even if the consumer could obtain that income by cancelling the policy. The proposed change to Code § 673 will have the identical effect as to preneed trusts.

Revenue Impact

The proposed change should have no material effect on tax revenues.

Preneed trust income now taxed to consumers generates little or no tax revenues. Most preneed consumers are in the lowest tax bracket or have insufficient income to generate any tax liability. As described above, revenues generated when income is taxed directly to the preneed trusts is insignificant when compared to the expenses of preparing and processing their returns.

No Impact on Other Trusts

The proposed change will only affect preneed trusts. It will have no impact whatsoever on the taxation of any other trust or transaction.

11MLPS-EE

MEMORANDUM

July 6, 1987

FROM: Funeral and Cemetery Industry Coalition

RE: Proposal Relating to Taxation of
Preneed Trust Income

EXECUTIVE SUMMARY

The Funeral and Cemetery Industry Coalition believes it is important to clarify and rationalize the federal income tax treatment of preneed funeral and cemetery trust income. The Coalition's proposal has two main elements:

- Income earned by a preneed trust would be taxed currently to the seller of the preneed contract. The tax character of that income would pass through to the seller.
- The seller would be entitled to an optional deduction for preneed trust income not distributed to him. The deduction would be restricted, in order to eliminate any possible tax shelter, and the deduction would be available only as to trusts with assets of less than $10,000 per preneed purchaser.

Through basis adjustments, preneed trust income ultimately would be taxed to the person who benefits from the income. The result would be similar to that obtained through the funding of preneed contracts through life insurance.

The proposal also contains a procedure for reporting by master trusts and other common trusts and a proposed technical correction to recent tax legislation affecting preneed trusts.

8300W

MEMORANDUM

July 6, 1987

FROM: Funeral and Cemetery Industry Coalition

RE: Proposal Relating to Taxation of Preneed Trust Income

This memorandum describes a proposal of the Funeral and Cemetery Industry Coalition to clarify and rationalize the federal income tax treatment of preneed funeral and cemetery trust income. The concept of the proposal is to arrive at a result for preneed trusts comparable to that obtained by the funding of preneed contracts with life insurance policies.

Idea of the Proposal

The proposal has two main elements:

First, the law would be made clear that sellers of preneed contracts are taxed currently on investment income earned by preneed trusts. This income would retain its federal income tax character in the seller's hands.

Second, the seller would be permitted an optional, offsetting deduction for taxable income generated by the preneed trusts, but only to the extent that such income is not currently available to the seller because it is retained in trust. To the extent that the income is distributed to the seller, no deduction would be permitted. The deduction would be permitted only for trusts with assets up to $10,000 per purchaser.

When the seller receives the preneed trust proceeds upon the purchaser's death, the seller would be taxed to the extent of deductions previously claimed on the trust. The seller would also, of course, be taxed on the corpus of the trust at that time as ordinary income.

The consumer who purchases the preneed contract would not be taxed currently on income earned by the preneed trust. He would be taxed only if and when he receives actual distributions from the trust, generally upon cancellation or revocation of his preneed contract.

Some state associations of funeral directors and individual sellers operate master trusts and common trusts for preneed funds. Under the proposal, these master trusts and common trusts would be permitted to file information returns with respect to their constituent preneed trusts on a combined or composite basis.

The proposal also includes an additional item to correct recent legislation affecting preneed trusts.

Enactment of this proposal would resolve conflicts and confusion in current law relating to the taxation of preneed trust income. Undistributed preneed trust income would, in effect, accumulate tax-free, and the person who receives the income would be taxed when he receives it. Enactment of the proposal also would simplify administration of preneed trusts, because it would eliminate the need for multiple Forms 1099 or 1041, reflecting very small amounts of income. At the same time, enactment of the proposal would provide a level playing field for preneed contracts funded through trusts, as compared with contracts funded through life insurance.

Implementation of the Proposal

The proposal would involve four amendments to the Internal Revenue Code of 1986 -- two substantive, one administrative and one in the nature of a technical correction. Committee report language would spell out tax consequences not addressed specifically in statutory language.

Statutory Amendments

The amendments would be as follows:

(1) The grantor trust provisions (section 673 or 677) would be amended to make clear that a seller of preneed contracts is the grantor and owner with respect to preneed trusts established pursuant to such contracts. The amendment would also make clear that this rule takes precedence over any possibly contrary statutory provision, especially section 676 (dealing with power to revoke). Accordingly, the seller would be taxed under section 671 on all preneed trust income, and this income would retain its character for federal income tax purposes in the seller's hands.

(2) Section 162, 461 or 642 of the Code would be amended to allow an optional deduction to the seller. The amount of the deduction each year would be equal to undistributed taxable income generated by the trust -- i.e., income (excluding tax-exempt income and tax-deferred income, such as income from annuities) net of expenses and net of any dividend-received deduction. This deduction would apply only to income of preneed trusts with corpus plus accumulated income of less than $10,000 per purchaser.

(3) Section 671 or section 6012(b) would be amended to permit preneed master trusts and/or other common trusts to file combined or composite information returns.

(4) Section 72(u), enacted in 1986, would be amended to permit preneed trusts to hold deferred annuities.

Committee Report Language

Committee report language would explain the concept of these amendments: The seller is deemed to receive all the net income of preneed trusts and then is deemed to recontribute all undistributed income back to the trusts. The seller is taxed on all the income of the trusts under section 671 and is entitled to an optional deduction for the deemed recontribution. Without this deduction, the seller would be taxed on income from which he has no current benefit, because of state law or contractual trusting requirements. That is, the rationale for the deduction is like the rationale of the case law which excludes payments by a preneed purchaser from the seller's taxable income, to the extent the payments remain in trust. See Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967) acq., aff'd 407 F.2d 210 (9th Cir. 1969), cert. denied, 396 U.S. 824.

The proposed deduction would be limited, however, to the amount of undistributed taxable income generated by the trusts. That is, to the extent the income is distributed currently to the seller, and to the extent the income is tax-exempt or tax-deferred to the seller, there would be no deduction under the proposal. Similarly, the amount of the deduction under the proposal would be reduced by the amount of any dividend-received deduction attributable to dividend income retained in the trust. The result is that preneed trusts would not serve as tax shelters to the seller.

Committee report language also would make clear that the seller could obtain step-ups to his basis in his interest in the trust. The amount of this step-up each year would be equal to all the income retained by the trust (including undistributed tax-exempt income and the dividend-received deduction attributable to retained dividends, but not including deferred income, e.g., from annuities), less expenses and less the amount claimed as a deduction for that year.

Thus, if the purchaser dies and both corpus and accumulated income are paid over to the seller who provides the funeral, then the seller would be taxed at the time of the funeral only on the corpus plus amounts previously deducted. If the seller did not claim deductions, he would be taxed only on corpus, since he would already have paid tax on the income.

If the purchaser revokes the preneed trust before death, then the seller would be taxed at the time of the revocation on preneed trust income distributed to him but only to the extent of his prior deductions. If, upon revocation, the purchaser is entitled to accumulated income as well as the corpus, then the purchaser would be taxed on all accumulated income distributed to him. The seller would be entitled to an ordinary loss deduction equal to his basis in the trust -- i.e., the accumulated income distributed to the purchaser, less amounts the seller has previously deducted under the proposal. Thus no Forms 1099 would be required except when income is distributed to the purchaser upon revocation. The trust itself would never be taxed.

Also, committee report language should address accounting matters, such as the computation of income and deductions in the event of mid-year distributions and possible accounting systems to permit sellers to account for preneed trust income on one or more aggregate bases. For example, the committee reports might state that individual accounting will not be necessary in situations where the seller receives current distributions of all trust income or where the seller is entitled to all trust income in all events.

Examples

The following examples illustrate the proposal:

1. On January 1, 1988, individual A purchases a preneed funeral contract from funeral director B. A pays $2,000 cash, and under state law that full amount is placed in a preneed trust. In 1988 the trust earns ordinary income of $170, and trustee fees and other expenses of the trust amount to $10. The $160 of net income is retained in the trust.

a. Under the proposal, B would be treated as the owner of the corpus of the trust and would be subject to tax on the net income therefrom, $160. B would also be entitled to an offsetting $160 deduction. B's basis in the trust would be zero, because the net income from the trust is offset completely by the deduction, and the corpus has never been taxed to him.

b. A dies on January 1, 1989, and the $2,000 corpus plus the $160 accumulated net income are distributed to B, who provides the funeral. B would be taxed in 1989 on $2,160 of ordinary income -- the $2,000 corpus, plus the $160 income which B had previously deducted.

c. Now assume that A does not die, but rather that he revokes his preneed contract on January 1, 1989, and that, under state law, A is entitled to the corpus of $2,000, plus the accumulated net income of $160. A would be taxed in 1989 on ordinary income equal to the $160 he receives in excess of his $2,000 payment of corpus to the trust. Since B has no basis in the trust, and since B receives nothing from the trust, the revocation would have no tax consequence to B.

d. Now assume that A revokes his preneed contract on January 1, 1989, but that, under state law, A is entitled only to the return of his $2,000 corpus, and B receives the $160 of accumulated net income. A would realize no income, gain or loss, and B would be taxed in 1989 on $160, the amount of his deduction in 1988.

e. Now assume that A revokes his preneed contract on January 1, 1989, but that, under state law, A is entitled to the return of his $2,000 corpus plus half the accumulated net income ($80), and B receives the remaining $80 of net accumulated income. A would be taxed in 1989 on ordinary income equal to the $80 he receives in excess of his $2,000 payment of corpus to the trust. Since B has no basis in his interest in the trust, and since B receives $80 from the trust, B is taxed on ordinary income equal to the $80 he receives from the trust.

2. The facts are the same as in Example 1, except that, under state law, B is entitled to current distributions of all net income earned by the trust. In this case, the $160 of net income would be taxed currently to B, and B would be entitled to no offsetting deduction.

3. On January 1, 1988, individual A purchases a preneed funeral contract from funeral home C, a C corporation. A pays $2,000 cash, and under state law that full amount is placed in a preneed trust. In 1988, the trust earns dividends of $100, tax-exempt income of $30 and interest income of $40. C is eligible for the full dividends-received deduction. Trustee fees and other expenses of the trust amount to $10. The full $160 of net income is retained in the trust.

a. Under the proposal, C would be treated as the owner of the corpus of the trust and would be subject to tax on the $130 of net income therefrom ($100 dividends plus $40 interest less $10 expenses -- tax-exempt income is excluded from gross income). S also would be entitled to a dividends-received deduction of $80 (80% of $100). Thus C would have taxable income from the trust, before the proposal's deduction, of $50 ($130 less $80). C would be entitled to a $50 deduction, and so C would be left with no currently-taxable income from the trust. C's basis in his interest in the trust would be $110 (net income of $160 in the trust, less the $50 deduction). Again, C has no basis in the trust corpus.

b. A dies on January 1, 1989, and the $2,000 corpus and the $160 accumulated net income are distributed to C, which provides the funeral. C would be taxed in 1989 on the $2,000 corpus plus $50 of trust income, the amount equal to C's prior deduction.

c. Now assume that A does not die, but that he revokes his preneed contract on January 1, 1989, and that, under state law, he is entitled to the corpus of $2,000, plus the accumulated net income of $160. A would be taxed in 1989 on the $160 he receives in excess of his $2,000 payment to the trust. The character of this income would not pass through to A. The income to A would be all ordinary income. C would be entitled to an ordinary loss deduction in 1989 of $110, his basis in the trust. ($160 net income in the trust less the $50 deduction).

d. Now assume that A revokes his preneed contract on January 1, 1989, but that, under state law, A is entitled only to the return of his $2,000 corpus, and C receives the $160 of accumulated net income. In this case, A would have no income, gain or loss, and C would be taxed in 1989 on $50, an amount equal to its deduction from 1988.

4. The facts are the same as in Example 3, except that, as authorized by state law, the trust distributes $25 of its income to C in 1988. The trust does not allocate the distribution to any particular earnings. Thus, the distribution would be apportioned pro rata among the types of income earned by the trust in 1988 -- 47.1% dividends-received deduction (80% of $100/$170), 11.8% remaining dividends (20% of 100/170), 23.5% tax-exempt income ($40/$170) and 17.6% taxable interest ($30/$170). Thus the distribution would be allocated as follows:

Dividends-Received Deduction	$11.77
Remaining Dividends	$ 2.95
Tax-Exempt Income	$ 5.88
Taxable Interest	$ 4.40

B's deduction for 1988 would be reduced by $7.35 ($2.95 plus $4.40), the taxable portion of the distribution, to $42.65. B's basis in his interest in the trust would be $92.35 ($160 net income less $25 distribution less $42.65 deduction).

Effective Date

The proposal would apply in full to preneed trusts formed after the date of enactment. It would also apply to taxable years beginning after enactment for trusts previously formed. In other words, the taxation and deductions to the seller would be put in place for these later years. Distributions from previously-formed trusts of income earned before the effective date would be taxed in a manner consistent with their prior treatment. In other words, income which was previously taxed to the purchaser would not be taxed to him again if distributed to him upon revocation. Income previously taxed to the purchaser would be taxed to the seller in full, however, when distributed to him upon the purchaser's death.

Under the proposal, years before the effective date would be taxed in accordance with any reasonable and consistent method adopted by the seller at that time.

REQUEST FOR TECHNICAL CORRECTION TO INSURE THAT SUBSTANDARD LIFE INSURANCE POLICIES WRITTEN USING THE AGE SET-AHEAD METHOD ARE NOT TECHNICALLY DISQUALIFIED UNDER THE DEFINITION OF LIFE INSURANCE

I. INTRODUCTION

The age set-ahead method of life insurance underwriting is one of the oldest methods of life insurance underwriting. Ambiguities in the Technical Corrections Act of 1984, as perpetuated by the Tax Reform Act of 1986, have cast doubt on its continued validity as an underwriting technique under the defintion of "life insurance" as set forth in Section 7702 of the Internal Revenue Code. For the reasons set forth below, we would urge an addition to HR 2636 to clarify the continued propriety of this well-recognized method of rating substandard insurance risks.

The Integrated Resources Life Companies (hereafter, "Integrated" or "IRLC") believe it is clear that the age set-ahead method of rating life insurance policies was not intended to be proscribed by Internal Revenue Code Section 7702. We review below the problem as we have identified it, together with a brief legislative history of the provisions in issue. Taken together, they support the need for a technical correction to clarify the continued propriety of the age set-ahead method.

II. APPARENT NEED FOR LANGUAGE CLARIFICATION

There are two common ways for a life insurance company to charge for substandard mortality. The more common method is simply to charge an extra premium each year, based on the "table" (the seriousness of the insured's condition) into which the insured falls.

The other method is to charge the insured a premium based on a higher age than his or her actual age. The age chosen by the company is that higher age at which mortality is the same as that which would be expected for a substandard insured. This is the method used by a number of life insurance companies, including Integrated.

The main question concerning the use of the age set-ahead method appears to be ambiguous language in the Deficit Reduction Act of 1984, as perpetuated in the Tax Reform Act of 1986, which requires certain guideline premium limitations to be met in order for a contract to be treated as life insurance. This ambiguity raises potential problems specifically when the age set-ahead is for more than five years. When this occurs, the policy will not reach endowment status between ages 95 and 100, as required by the statute. (For example, a whole life policy issued for an age set-ahead of 10 years matures at insurance age 100 when the insured's actual age is 90). Because the law does not specify that the test can be based on an insurance age that is different than the insured's actual age, the age set-ahead method of calculation falls into a gray area under the statute.

At present, this technicality could nullify one of the oldest methods of rating substandard risks. It is as well a method much simpler for the life insurance consumer to understand -- a main reason for its use. Clarifying language would accordingly be appropriate to allow the continued use of this method.

One concern expressed about the age set-ahead method is that it appeared to be an arrangement to permit an increase in cash value at lower ages that may be advantageous for some taxpayers who would benefit from paying higher premiums, and thereby be provided with a greater amount of tax-free build-up. This raises the "investment orientation" issue -- which in this case is a non-issue. The Exhibits provided herein demonstrate that no such increase in the cash value at lower ages occurs using the ASA methods.

Indeed, our calculations (as set forth in the attached Exhibits) indicate that the accumulated cash value is less for those insureds when the age set-ahead method is used. The Exhibits provided also present a detailed breakdown of substandard life insurance policies using the ASA method for insureds aged 35, 45, and 55. The policies represented in the Exhibits are "no-load" policies, for which mortality information is based on the industry recognized 1980 CSO. The following briefly reviews each Exhibit.

Exhibit I:

The three illustrations that comprise Exhibit I indicate that, for the same amount of gross premium, a step-up in age results in less insurance and a lower rate of return. The taxpayer cannot benefit from paying higher premiums in order to get a greater amount of tax-free build-up. This illustrates that the age set-ahead method is merely a practical approach to place a substandard insured at the proper mortality level. It cannot be used to bypass Section 7702, for it has no inherent investment orientation.

For example, a 35 year old male in the tenth policy year (without age set-ahead) has a policy accumulated value of $18,378 with a death benefit of $100,000. If a step-up in age of ten years is assumed (to age 45) the accumulated value in the tenth year is $17,195, and the death benefit is $61,084. In short, the same premium that purchased $100,000 of coverage for a 35 year old purchases less coverage, and has a lesser accumulated value in the tenth year, for a policyholder age 35 with a step-up in age of ten years. The three charts in Exhibit I consistently follow this pattern.

Exhibit II:

Exhibit II compares the accumulation value, net single premiums, and adjusted death benefit under the cash accumulation tests of Section 7702 for defining life insurance as calculated for a 45 year old applicant considered under the mortality tables and a 45 year old applicant assuming an age set-ahead of nine years (to insurance age 54). The comparison reveals that the use of the ASA method allows, again, for less accumulation value than the accumulation value present not using the ASA method.

For example, using Table D(4), a policy issued to an applicant age 45 would, in a tenth policy year (by which time the insured would have attained age 55) have an accumulated value of $43,910, with a death benefit of $100,336. Using the ASA method to set-ahead the age of the insured nine years to insurance age 54, after the tenth policy year (at which time the insured's policy age would be 64) the accumulated value is $42,444, with a death benefit of $92,847. The figures are obviously quite close.

Exhibit II shows fairly conclusively that the age set-ahead method calculated using recognized mortality figures (1980 CSO) compares favorably with other methods of rating substandard mortality. It produces results that are eminently consistent with the use of a multiple of the standard cost of insurance rates, a method recognized as being acceptable under Section 7702. In sum, the ASA method is a time-tested, reasonable, and valued method for rating substandard mortality, and produces results consistent with other methods recognized as acceptable.

II. THE LEGISLATIVE HISTORY REVEALS AN ATTEMPT TO LIMIT INVESTMENT-ORIENTED POLICIES, NOT A PROSCRIPTION OF THE AGE SET-AHEAD METHOD

Prior to the passage of the Deficit Reduction Act in 1984, the definition of life insurance in the Internal Revenue Code was essentially glossed over by reference in such sections as Section 1035 ("Certain Exchanges of Insurance Policies", *see especially* Section 1035(b)(3)) and Sections 1817, 1818 ("Treatment of Variable Contracts"; "Other Definitions and Special Rules"). The Deficit Reduction Act set out the Code's first comprehensive definition.

That comprehensive definition (including the computational rules in issue) was enacted, however, to address a major concern of Congress, often expressed, to contain the "proliferation of investment-oriented life insurance policies." (*See*, H.R. Rep. No. 432, 98th Cong., 2d. Sess. 1445, *reprinted in* 1984 U.S. Code Cong. and Ad. News, 698, 1088, (hereinafter "House Report", p. _"). The Blue Book prepared by the Staff of the Joint Committee on Taxation likewise noted that because of this "general concern", the definition of life insurance was "narrowed in some respects." *General Explanation Of The Revenue Provisions Of The Deficit Reduction Act Of 1984, Prepared By The Staff Of The Joint Committee On Taxation* (December 31, 1984), page 646 (hereinafter "Staff Report", p. ___).

The change adopted in the approach to endowment contracts evidenced the basic rationale for the terms of Section 7702(e). Whereas Section 1035(b)(3) through reference to Section 1035(a)(1) included endowment contracts in the definition of life insurance, the *amended* definition of life insurance *excluded* such contracts from the definition of life insurance due to their "innate investment orientation." House Report, p. 1443; Staff Report, p. 647.

The Staff explanation makes this clear in a number of places. For example:

> The [new] rules *restrict* the actual provisions and benefits that can be offered in a life insurance contract. . . in order to *limit the investment orientation of insurance contracts*.

Staff Report, p. 651. In short, the use of thinly-veiled investment vehicles ostensibly styled as life insurance contracts was to be remedied by the amended definition of life insurance and the computational rules of Section 7702(e) enacted under the Deficit Reduction Act.

At the same time, express language was added to the Act, and discussed in the Staff Report, to the effect that contracts which adopt age adjustment features may be recognized as appropriate. For example, there are two substantive tests under which a contract may qualify as a life insurance contract: the cash value accumulation test, and the guideline premium and cash value corridor test. The computational rules applicable to both substantive tests state that the maturity date of the contract is "*deemed to be*" no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Two of the three exceptions analyzed in the Staff Report are particularly instructive. We believe they resolve any doubts or questions concerning the acceptability of the ASA method. First, it is noted that, concerning a second method of age adjustment -- age *set-back* for female insureds -- an actual contract maturity date *later than* age 100 *will qualify* under the computational rule.

More importantly, it is expressly stated that:

> Similarly, a contract written with a termination date before age 95 (e.g., term life insurance to age 65), which otherwise satisfies the requirements of Section 7702, will qualify as a life insurance contract for tax purposes.

Staff Report, p. 652 (emphasis added). In short, not only are contracts using the ASA method quite similar in all respects with the values -- accumulated values and death benefits -- employed in "traditional" contracts, and thus do not represent "innate investment vehicles", but they otherwise satisfy the requirements of Section 7702. Indeed, ASA life insurance contracts are merely an example of an age adjustment method for rating life insurance policies, a method expressly recognized as encompassed within the terms of "life insurance" under Section 7702 as explained by the Staff Report.

The changes in the Tax Reform Act of 1986 concerning § 7702(e)(1)(B) conformed the language of subparagraph (B) with that of subparagraphs (A), (C), and (D), so that the maturity date of a life insurance contract would be "deemed to be" no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. The prior hard-and-fast requirement that the maturity date "will be" no earlier than the date on which the insured attains age 95 and no later than the date the insured attains age 100 thus gave way to a more flexible approach fully in accord with the position that ASA is an appropriate methodology.

For these reasons, we would urge that any remaining ambiguity concerning the ASA method be eliminated through the adition of a Technical Correction recognizing the propriety of ASA policies under the Section 7702 definition of life insurance, by the addition of the following language to subsection (i) of Section 118 of Title I of HR 2636:

> (i) AMENDMENT RELATED TO SECTION 1825 OF THE REFORM ACT.-
>
> (1) Paragraph (1) of section 1825(a) of the Reform Act (relating to amendments related to section 221 of the Tax Reform Act of 1984) is amended by striking out "on which the insured attains age 95, and no later than the day on which the insured attains age 100" and inserting in lieu thereof "on which the insured attains insurance age 95, and no later than the day on which the insured attains insurance age 100."
>
> (2) Paragraph (4) of section 1825(a) of the Reform Act (relating to amendments related to section 221 of the Tax Reform Act of 1984) is amended by striking out "Section 7702(e)(2)" and inserting in lieu thereof "Effective with respect to contracts entered into after October 22, 1986, section 7702(e)(2)."

We would be pleased to respond to any questions concerning the proposed amendment.

Respectfully submitted,

Daniel J. Piliero II

Daniel J. Piliero II
On behalf of the Integrated
Resources Life Companies

Date: July 17, 1987

Exhibits I

ILLUSTRATION FOR AN AGE 35

Gross Annual Premium = $1,378.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	35		40		45		50		55	
Initial Face Amount	100,000		78,984		61,084		46,720		35,605	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	7,370	100,000	7,170	78,984	6,934	61,084	6,692	46,720	6,350	35,605
10	18,378	100,000	17,794	78,984	17,195	61,084	16,548	46,720	15,812	35,605
15	34,608	128,120	33,414	101,149	32,114	80,689	30,783	65,270	29,255	53,185
20	57,255	173,325	54,742	137,543	52,116	110,370	49,332	89,683	46,339	73,774
25	87,923	220,915	83,080	175,905	77,932	141,676	72,674	115,702	66,943	95,777
30	128,510	272,062	119,456	217,169	110,190	176,430	100,528	143,828	91,305	119,695
35	180,349	327,865	164,650	262,149	148,370	212,277	133,212	174,633	119,035	146,075
40	244,535	389,317	217,833	311,658	192,909	252,809	170,131	208,778	152,400	174,497
45	319,695	457,396	279,584	366,518	242,918	298,099	214,487	245,587	191,269	191,269
50	405,687	533,144	348,598	427,785	302,932	346,855	265,993	265,993	MATURED	MATURED
55	503,572	617,963	431,345	493,888	372,438	372,438	MATURED	MATURED		
60	619,657	709,503	526,986	526,986	MATURED	MATURED				
65	753,623	753,623	MATURED	MATURED						
Internal Rate Of Return	5.29%		5.07%		4.84%		4.60%		4.34%	

Exhibits I

ILLUSTRATION FOR AN AGE 45

Gross Annual Premium = $2,240.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	45		50		55		60		65	
Initial Face Amount	100,000		76,485		58,289		44,585		34,182	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	11,352	100,000	10,955	76,485	10,396	58,289	9,798	44,585	9,000	34,182
10	28,189	100,000	27,085	76,485	25,887	58,289	24,618	44,585	23,235	34,182
15	52,574	132,095	50,395	106,689	47,894	87,069	45,330	72,168	42,500	60,806
20	85,318	180,624	80,761	146,819	75,861	120,776	70,658	101,092	65,757	86,204
25	127,581	231,936	118,974	189,416	109,593	156,797	100,892	132,263	92,797	113,877
30	180,391	287,194	164,574	235,460	149,475	195,954	135,636	166,447	125,461	143,652
35	242,895	347,516	218,080	285,891	194,872	239,139	177,515	203,253	163,851	163,851
40	315,809	414,008	278,520	341,789	249,494	285,669	226,499	226,499	MATURED	MATURED
45	397,679	488,015	351,136	402,048	313,127	313,127	MATURED	MATURED		
50	495,027	567,833	435,456	435,456	MATURED	MATURED				
55	609,715	609,715	MATURED	MATURED						
Internal Rate Of Return	4.86%		4.63%		4.37%		4.09%		3.78%	

Exhibits I

ILLUSTRATION FOR AN AGE 55

Gross Annual Premium = $3,825.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	55		60		65		70		75	
Initial Face Amount	100,000		76,490		58,642		45,136		34,571	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	17,835	100,000	16,810	76,490	15,441	58,642	13,906	45,136	11,853	34,571
10	44,411	100,000	42,235	76,490	39,861	58,642	37,201	47,788	34,599	40,376
15	82,167	149,374	77,768	123,811	72,913	104,318	68,307	89,547	63,916	78,435
20	130,146	207,202	121,220	173,433	112,812	147,890	104,938	128,775	99,457	113,877
25	188,017	269,000	173,090	226,911	159,201	195,365	149,302	170,950	141,755	141,755
30	256,438	336,176	232,697	285,556	215,239	246,447	201,744	201,744	MATURED	MATURED
35	334,321	410,265	304,544	348,701	281,100	281,100	MATURED	MATURED		
40	428,029	490,090	388,581	388,581	MATURED	MATURED				
45	537,198	537,198	MATURED	MATURED						
Internal Rate Of Return	4.39%		4.11%		3.80%		3.43%		2.91%	

Exhibits II

45 Year Old Applicant Table D(4) Substandard Class
Gross Premium for an Issue Age 54 used in each Illustration

		Issue Age 45 200% of 1980 CSO				Insurance Age 54 Age Set Ahead to 54		
Policy Year	Attained Age	Accum Value	NSP 200%	Death Benefit	Attained Age ASA 9 Yrs	Accum Value	NSP 100%	Death Benefi
10	55	43,910	437.63	100,336	64	42,444	457.14	92,84
15	60	80,878	513.25	157,580	69	78,601	534.29	147,11
20	65	128,586	591.94	217,228	74	124,892	612.97	203,74
25	70	187,765	668.87	280,720	79	181,007	685.24	264,15
30	75	258,952	741.41	349,270	84	247,635	751.01	329,73
35	80	340,021	801.26	424,358	89	323,575	804.96	401,97
40	85	431,978	851.72	507,183	94	413,070	859.28	480,71
45	90	532,694	887.54	600,192	99	523,772	943.40	555,19
50	95	646,390	920.81	701,904		----------Matured------		
55	100	704,887	1000.00	704,887		----------Matured--		

Section 1848:

VANSTONE & KROCHTA *Attorneys*
TENTH & SYCAMORE STS. · P. O. BOX 3115 · EVANSVILLE, INDIANA 47730 · (812) 426-2811

JACK N. VANSTONE
THOMAS G. KROCHTA

August 21, 1987

Senator Dan Rostenkowski
Chairman, House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Senator Rostenkowski:

I am writing you about Title 26 Section 2039 (e) of the Internal Revenue Code, which deals with the exclusion of IRA's from Federal Estate Taxes. Indiana recently amended it's Inheritance Tax Code to provide that those items which are includable under Section 2039 under the Federal Statute are now includable for Indiana Inheritance Tax purposes.

There is a confusion. Section 525 (a) of the Tax Reform Act of 1984 repealed Subsections (c), (d), (e), (f) and (g), and at the same time Section 491 (b) (34) (A) amended 2039 (e) (3); and Section 491 (b) (34) (B) amended 2039 (e) (2); and Section 491 (b) (34) (C) amended 2039 (e) (1).

Obviously, one Statute cannot both repeal and amend. I do not think you intended to repeal (e) because the report does not in any way talk about Subsection (e), but in fact is a report regarding the $100,000 limit and interest created by community property laws; and, there is nothing in the reports about the IRA exemptions contained in Subsection (e).

In addition, the Tax Reform Act of 1986, Section 1848 (d) amended Section 2039 (e), and if Section 2039 (e) had been repealed it would not be there to be amended in 1986.

The State of Indiana is taking the position that Subsection (e) was repealed and therefore all IRA's are included for Indiana Inheritance Tax purposes. I have been **taking the position that Subsection (e) was not repealed but was in fact amended, and that what is left after it is** amended exempts certain **IRA's** from tax.

I would appreciate any assistance you can give me in the resolution of this dilema.

Sincerely,

VANSTONE & KROCHTA

Jack N. VanStone

Jack N. VanStone

Section 1851:

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BERT N. BISGYER
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OF COUNSEL

July 2, 1987

HAND DELIVERED

Robert Leonard, Esquire
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This is in response to the request for comments on H.R. 2636, The Technical Corrections Act of 1987. These comments are submitted on behalf of James J. Albertine, Director of Government Affairs, American Society of Association Executives ("ASAE"). A brief biographical statement concerning ASAE is enclosed for your information. ASAE seeks to have repealed Section 1851(a)(10) of The Tax Reform Act of 1986. That Section eliminated the exclusion granted 10 or more employer funded welfare plans from the tax on unrelated business income in the Deficit Reduction Act of 1984 ("DEFRA").

Background

DEFRA added Sections 419 and 419A to the Internal Revenue Code ("Code"), imposing new requirements and limitations on funded welfare benefit plans. DEFRA also added new rules for calculating unrelated business taxable income ("UBTI"), which limit the amount of assets that can be accumulated tax-free in a welfare benefit trust. Under these new rules, excluded amounts set aside for an exempt purpose are generally limited to the account limit for prefunding welfare benefits under the deduction limitation rules contained in Code Section 419A(c). If the reserves in the welfare benefit fund exceed the account limit set by these rules, then the excess reserves or UBTI must be included in the sponsoring employer's gross income. However, the express language of Code Section 419A(f)(6), as added by DEFRA, creates an exclusion from the deduction limitation and UBTI rules of Code Sections 419 and 419A by providing that "[t]his subpart shall not apply in the case of any welfare benefit fund which is a part of a 10 or more employer plan" (emphasis added). Nevertheless, the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 ("bluebook"), on page 791, states that "the limit on the set-aside is intended to apply to more than 10 employer VEBAs which are exempt from the deduction limitations". A footnote on the same page concedes that a technical correction may be necessary so that the Code reflects this intent.

The technical corrections provisions of the Tax Reform Act of 1986 subject the trust income held by 10 or more employer funded welfare plans to taxation for exceeding the maximum reserve limits in Section 419A of the Code. Thus, Section 1851(a)(10)(A) amends Code Section 512(a)(3)(E)(i) to provide that unrelated business income will be "determined without regard to Subsection (f)(6)" of Code Section 419A.

Section 419A(g) of the Code was added by DEFRA. It requires participating employers in a funded welfare benefit plan to include in income an amount based on the plan's unrelated income for the plan's taxable year ending within the employer's taxable year if the plan had income on excess reserves. This tax is evidently in addition to any tax imposed by Section 641 of the Code, which imposes a tax on estates and non-grantor trusts. Section 419A(g) requires that the amounts of deemed income of participating employers be treated as distributed to them for income tax purposes each year that there is income when there are excess reserves. Section 419A(g)(3), as added to the Code by Section 1851(a)(9) of the Tax Reform Act of 1986, requires each affected employer to report to the plan its tax paid for the plan to determine its non-taxable reserve for the following year.

ASAE's Position

ASAE believes there are compelling policy reasons why the UBTI rules should not apply to 10 or more employer funded welfare plans. Many of the participating organizations in 10 or more employer plans are small employers that are members of trade associations. These plans provide important health, life and other welfare benefits to the employees of small employers. Many small employers could not purchase these benefits at a reasonable price, or in some cases at any price, unless trade associations maintained these plans for the employees of their members. The cost of health and welfare benefits are soaring. Changing demographics, medicare cutbacks and medical inflation make it difficult for small employers to pay for these benefits. Adding an extra tax and administrative burden to these plans would make the protection more expensive to small employers.

These plans must maintain adequate and prudent reserves because participating employers frequently leave these plans before benefit obligations are satisfied. Adequate reserves are important to assure that people receive their benefits from these plans, particularly since Congress and the courts are placing greater responsibilities on these plans. For example, the government has shifted more of the medical costs and welfare benefit responsibility to the private sector. Further, these plans are often required to establish special reserves for retroactive insurance premiums or for run out claims that may not be able to be categorized as "incurred but unpaid" claims under Section 419A(c) of the Code. That is, these special reserves may exceed the safe harbors in DEFRA. But, many of these plans would be unable to retain adequate reserves without being subject to income taxation under the UBTI rules.

Individual employers do not control the operation of a 10 or more employer plan. Competition in the market place limits the reserves in these plans. Accordingly, the possibility of abuse in these plans is limited because these plans are subject to competitive market pressures for the cost of benefits.

The sentiment for exempting 10 or more employer funded welfare benefit plans from the tax on excess reserves was addressed by Senator Packwood and Senator Bentsen in a colloquy which appeared in the Congressional Record on June 24, 1986. In their colloquy, the Senators registered their concerns about the effects the technical corrections section of the Tax Reform Act of 1986 would have on 10 or more employer funded welfare benefit plans. A copy of the colloquy as printed in the Congressional Record is enclosed.

With respect to Section 419A(g) of the Code, assuming 10 or more employer funded welfare benefit plans are not exempted from the tax on excess reserves, ASAE believes that the tax should be imposed only at the trust level and that the tax should be imposed solely under Section 641 of the Code. There is no public policy purpose served by imposing a secondary tax on a 10 or more employer funded welfare benefit plan. Also, a tax at the employer level is administratively burdensome and costly, and ultimately unworkable, because (1) there may be hundreds or thousands of small employers in the plan, (2) the employers' taxable year ends occur at different times throughout the year, (3) the employers' tax return due dates are likely to be different and may make it impossible to coordinate and administer the rules in Section 419A(g), and (4) each of the employers and the fund must coordinate the information contained in and the timing of their tax returns.

Requested Relief

ASAE believes it necessary for the tax laws to encourage the maintenance and growth of 10 or more employer funded welfare plans. Therefore, ASAE requests that Congress restore the exemption from the tax on excess reserves afforded to 10 or more employer funded welfare plans under DEFRA. This can be accomplished in H.R. 2636, the Technical Corrections Act of 1987, by deleting Section 1851(a)(10) of the Tax Reform Act of 1986. Alternatively, if 10 or more employer funded welfare benefit plans are not exempted from the tax on excess reserves, ASAE requests that the rules under Section 419A(g) of the Code be modified so that a tax is imposed at the trust level only and solely under Section 641 of the Code.

ASAE appreciates the opportunity to present its views on this important issue. We would welcome the opportunity, should you find it helpful, to schedule a meeting with me and a representative or representatives from ASAE to discuss this issue in greater detail.

Sincerely,

SANDERS, SCHNABEL & BRANDENBURG, P.C.

Dan S. Brandenburg

Dan S. Brandenburg

BIOGRAPHICAL STATEMENT

ON THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of nearly 14,000 individuals representing more than 7,500 national, state, and local associations. The overwhelming majority of ASAE's members represent tax-exempt organizations, most of which are either tax-exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations either sponsor or are contemplating sponsoring funded welfare benefit plans.

June 24, 1986 CONGRESSIONAL RECORD — SENATE S 8261

Mr. BENTSEN. Mr. President, I would like to engage the distinguished chairman of the Finance Committee in a colloquy regarding so-called 10-or-more employer funded welfare benefit plans. I am concerned about a provision in the technical corrections section of the tax bill relating to 10-or-more employer funded plans. The provision specifically states that these plans would be subject to taxation on the income from their surplus reserves.

The 10-or-more plans provide a necessary avenue for many smaller businesses to obtain medical and other benefit coverage for their employees through their trade association. The businesses that participate in these plans would otherwise be unable to obtain coverage at group rates for their employees. In order to facilitate coverage for these businesses, the present Tax Code excludes these plans from the limitation rules on employer deductions for plan contributions.

These plans are unique in several ways. First, the participating employers do not control the operation of the plan. Because the member employers can come and go, the plans have a built-in incentive to keep their reserves and premiums lower to remain competitive. Most of these plans prohibit reversions of surplus assets to the contributing employers. These plans, then, would not be candidates for abuse if the exemption from taxation of the surplus reserves is maintained.

In summation, I am concerned that, by subjecting these plans to taxation on the income from their excess reserves, we would raise the cost to businesses of maintaining important insurance coverage for their employees. Therefore, I request the chairman's assurance that this important issue will be revisited in conference.

Mr. PACKWOOD. I agree with the Senator of Texas that we should carefully consider the tax treatment of welfare benefit funds maintained by 10 or more employers. The law exempts employers from limits on deductions for contributions to such plans, but does not exempt the plans from taxation if total assets exceed these limits. This is a very important issue relating to the ability of employees to provide benefits to their employees, and it is an issue that should be revisited in conference.

Section 1852

INTRODUCTION

Prior to December 31, 1982 there was always an exclusion in the Internal Revenue Code for unused company-sponsored retirement plan proceeds from the gross estate for estate tax purposes. In addition, Congress has a history of grandfathering prior tax treatment with new tax legislation. With the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Congress reversed its position on both these issues when the estate tax exclusion for pension and profit sharing benefits was reduced to $100,000. This testimony proposes a technical correction which matches the legislative history of taxation of retirement proceeds in that prior to 1983 there was an exclusion for unused retirement plan benefits.

HISTORY

History of Federal Estate Tax Treatment of Lump Sum Distributions from Qualified Plans After Participant's Death:

1. Prior to December 31, 1978: Pre Tax Reform Act of 1976.

   Internal Revenue Code section 2039 excluded lump sum distributions to named beneficiaries from qualified plans in determining the federal gross estate regardless of how the beneficiary elected to treat the distribution for income tax purposes.

2. January 1, 1979 - December 31, 1982: Tax Reform Act of 1976.

   The Tax Reform Act of 1976, P.L. 95-600, Section 142(b), amemded I.R.C. section 2039 by adding paragraph (f) requiring that for estates of decedents dying after December 31, 1978, the lump sum distribution from the qualified plan was excluded in determining the federal gross estate only if the recipient irrevocably elected to treat the distribution as currently fully taxable as ordinary income under I.R.C. section 402 (a) - i.e. the recipient of benefits elected not to use capital gains treatment or 10 year forward averaging for income taxation of the distribution. Capital gain treatment of pre-1975 retirement plan benefits was grandfathered using a months-of-participation method in this legislation.

3. January 1, 1983 - December 31, 1984: Tax Equity and Fiscal Responsibility Act of 1982.

   The Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, Section 245(a), amended I.R.C. section 2039 by adding paragraph (g) which limited the exclusion for federal estate tax purposes to $100,000 and applied to estates of decedents dying after December 31, 1982. The restrictions on income tax treatment of the distribution continued - if the estate used the $100,000 exclusion of retirement plan benefits, then capital gain treatment and 10 year forward averaging could not be used.

4. January 1, 1985 - December 31, 1986: Deficit Reduction Act of 1984.

   A. The Deficit Reduction Act of 1984, P.L. 98-369, Section 525(a) amended I.R.C. section 2039 by deleting paragraphs (c) - (g) and repealing the $100,000 exclusion of lump sum distributions from qualified plans for federal estate tax purposes for estates of decedents dying after December 31, 1984.

   B. A complete estate tax exclusion was provided under section 525 (b)(3) for persons meeting the following criteria:
      1. Retired prior to 1982;
      2. Were in "pay status" on December 31, 1982; and
      3. Made an irrevocable election as to the form of the benefits to received.

      Recipients of retirement plan benefits which have been excluded from the estate cannot use the special income tax treatment for the benefits received.

5. January 1, 1987 - Present: Tax Reform Act of 1986.

The Tax Reform Act of 1986, P.L. 99-514; Section 1852(e) 3, amended I.R.C. Section 2039 by adding paragraph (4) which deletes the requirement that the participant in the qualified plan be in "pay status" and have made an irrevocable election as to the form of benefit payments. A plan participant only needs to have retired prior to 1982 to receive complete exclusion of retirement plan benefits from estate tax or retired in 1983 or 1984 to receive a $100,000 exclusion. The benefits were subject to ordinary income tax. It should be noted that Congress grandfathered 10 year forward averaging income tax treatment for those individuals who were at least 50 years old on January 1, 1986.

History of Exacto Spring Corp Retirement Plans:

In 1960, three men felt they could do a better job of manufacturing precision springs than other companies in existance. They left their employment and started Exacto Spring Company on $9000 of borrowed money. In 1962 the company was incorporated as Exacto Spring Corp. In 1963 the company made enough of a profit to start a profit sharing plan to begin saving for the retirement of owners and employees. The owners were 31 years old at the time. In 1963 the company contributed $2,280 to the Profit Sharing Plan for each of the three owners - a rather inauspicious start. In 1964 the company again made a contribution to the profit sharing plan for each of the owners of less than $4,000. Also in 1964 the company instituted a pension plan to provide for employee retirements.

From those small contributions in 1963 and 1964, the Profit Sharing Plan assets have grown to more than $6,000,000 covering 70 employees and the Pension Plan assets have grown to more than $2,500,000 covering 50 employees.

Throughout the history of the Plans, Exacto Spring Corp has encouraged employees to make voluntary, personal after-tax contributions to the Plans. This was done to provide the best possible savings program for the employees of Exacto.

PROBLEM

The 1982 TEFRA provision eliminating the estate tax exemption for qualified company-sponsored retirement plans was prospective on its face in that the provision became effective for decedents dying after December 31, 1982. However, the problem occurs when one considers the fact that the decedent would have saved those benefits prior to 1983. Thus, the provision became effectively retroactive in that amounts saved which had previously been excluded from the estate for estate taxation were now included in the estate and taxed at the higest marginal estate tax rate. This consequence is totally unfair to individuals who saved for as many as forty (40) years for retirement under the belief that the unused retirement benefits would not be subject to estate tax at their death. To change the rules to the detriment of these people who saved their own money for retirement is grossly unfair.

Congress has attempted to correct the retroactive effect of the 1982 TEFRA provision with respect to the estate tax exemption for qualified company-sponsored retirement plans in both 1984 and 1986. Ultimately, Congress has provided an estate tax exclusion only for those persons who retired from employment at December 31, 1982 or a $100,000 exclusion for those persons who retired in 1983 and 1984. This "grandfather" provision does not correct the retroactive effect of TEFRA. As a result amounts saved prior to 1983 by persons who have continued to work are still taxed in the gross estate. In looking at TRA of '86 section 1122(h)(5)-(7) we find that Congress grandfathers the election of 10-year forward averaging and Capital Gain provisions for qualified retirement plan participants who have reached the age of 50 prior to January 1, 1986. Congress has shown an intent to grandfather special income tax treatment of retirement plan distributions.

Since prior to the 1982 TEFRA the participant elected to take either preferential income tax treatment of the plan benefits or an estate tax exclusion for unused plan benefits, then Congress has not completed the grandfather provisions with respect to the other half of the election - the estate tax exclusion. To complete the grandfathering of pre-1983 income and estate taxation provisions with respect to qualified retirement plan benefits, Congress needs to grandfather the election to exclude unused retirement benefits from the gross estate if special income tax treatment is not used.

CONSEQUENCE

The unintended consequence of taxing pre-1983 retirement savings in the estate is that in the case of a person dying in 1988 whose estate exceeds $600,000 ($1,200,000 if married and using the marital deduction) the estate will pay combined income and estate tax of 64% of the death benefits received from qualified company-sponsored retirement plans. This provision not only affects small business owners in America, but can affect executives in all sizes of businesses and production workers whose employers had the foresight to provide good retirement benefits.

Attached is an analysis (Exhibit A) which indicates that had the company known in 1962 when Exacto Spring started its Pension and Profit Sharing Plans that the unused retirement benefits would be taxed in the estate of the retiree, participants would have been better off to take the money in compensation, pay the tax and gift the balance directly to beneficiaries each year. The result of this is that you are now telling the employees of Exacto and other small businesses that you really don't want us to save for retirement but rather take the money now and either gift it away or spend it. This approach is in conflict with my entire life's philosophy of working hard, reinvesting the Company's earnings into development of new products and new markets and to live conservatively saving for future progress.

SOLUTION

Congress is on the right track with providing technical corrections in the 1984 Deficit Reduction Act and the 1986 Tax Reform Act. The history of qualified company-sponsored retirement plan benefit, taxation has been that the recipient has the choice to either (1) use special income tax treatment consisting of capital gains and 5 or 10 year forward averaging or (2) excluding the benefit proceeds from the gross estate for estate taxation. Congress has consistently grandfathered the special income tax treatment to plan participants. Congress must grandfather the estate tax exclusion for all amounts saved for retirement prior to 1983 to complete the pre-1983 elections available to recipients of plan benefits. We propose a months-of-participation method such as was used in 1974 to grandfather the capital gains treatment for income taxation of lump sum distribution of pension and profit sharing benefits. Only by allowing plan participants the complete pre-1983 elections which include exclusion of pre-1983 retirement plan savings from estate tax can true equity be achieved for those persons who save for retirement under pre-TEFRA rules.

We would be pleased to submit proposed corrective language to the committee on request.

Respectfully submitted,

Exacto Spring Corp Profit Sharing Plan
Exacto Spring Corp Pension Plan
William J. Heitz, Trustee
Daniel R. Linsley, Plan Administrator

EXHIBIT A

Assumptions used:

1. The company started its profit sharing plan in 1962.
2. The Plan earned approximately 9.77% compounded annually on its investments.
3. The participant and his wife died simultaneously.
4. There are two (2) children in the family.
5. The participant was always in the 50% tax bracket.
6. A gift tax was paid out of the amount of the gift when applicable.
7. The interest earned by the children on the accumulated gifts was 9.77%.
8. The children were in the 15% tax bracket until 1978, at which time they entered the 25% bracket (28% in 1986).
9. Five Year forward averaging and capital gains treatment were used in the income tax calculation.
10. The marginal estate tax rate of 55% was used to calculate the estate tax on the profit sharing distribution.

All of the above assumptions except for death of the participant and spouse, along with the fact that the participants were not always in the 50% tax bracket, are historically accurate for the Exacto Spring Corp Profit Sharing Plan.

EXHIBIT A (Page 2)

Calculation of Retirement Plan
Proceeds Using Tax Reform of 1986:

	Make Contribution to Profit Sharing Plan			Take Salary, Pay Tax and Gift Balance to Children		
Year	Profit Sharing Contribution	Profit Sharing Earnings	Total	Salary After Tax	Earnings	Total
1963	$2,280	$223	$2,503	$1,140	$95	$1,235
1964	$3,925	$245	$6,672	$1,963	$103	$3,300
1965	$5,625	$652	$12,949	$2,813	$274	$6,386
1966	$5,718	$1,265	$19,932	$2,859	$530	$9,776
1967	$7,350	$1,947	$29,230	$3,675	$812	$14,262
1968	$9,750	$2,856	$41,835	$4,875	$1,184	$20,322
1969	$9,750	$4,087	$55,673	$4,875	$1,688	$26,884
1970	$10,203	$5,439	$71,315	$5,102	$2,233	$34,219
1971	$10,830	$6,967	$89,112	$5,415	$2,842	$42,475
1972	$11,400	$8,706	$109,219	$5,700	$3,527	$51,703
1973	$14,870	$10,671	$134,759	$7,435	$4,294	$63,431
1974	$18,401	$13,166	$166,326	$9,201	$5,268	$77,899
1975	$15,856	$16,250	$198,432	$7,928	$6,469	$92,297
1976	$13,658	$19,387	$231,477	$6,829	$7,665	$106,790
1977	$22,314	$22,615	$276,407	$11,157	$8,868	$126,816
1978	$23,443	$27,005	$326,855	$11,722	$9,292	$147,830
1979	$20,095	$31,934	$378,883	$10,048	$10,832	$168,709
1980	$29,703	$37,017	$445,603	$14,139	$12,362	$195,210
1981	$37,795	$43,535	$526,934	$18,898	$14,304	$228,412
1982	$30,000	$51,481	$608,415	$15,000	$16,737	$260,149
1983	$30,000	$59,442	$697,857	$15,000	$19,062	$294,211
1984	$30,000	$68,181	$796,038	$15,000	$21,558	$330,769
1985	$30,000	$77,773	$903,811	$15,000	$24,237	$370,006
1986	$30,000	$88,302	$1,022,113	$15,000	$26,028	$411,034
	Income tax		($145,052)			$0
	Excise tax		($17,754)			$0
	Estate tax		($562,162)			$0
	Remainder after tax		$297,145			$411,034

Section 1853

RICHARD A. GEPHARDT
3rd District, Missouri

WAYS AND MEANS COMMITTEE

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HOUSE OF REPRESENTATIVES
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July 17, 1987

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
1102 Longworth HOB
Washington, D.C. 20515

Dear Dan:

In the Tax Reform Act of 1986, the Congress attempted to clarify what constituted and who was entitled to utilize "no-additional-cost service" fringe benefits. Under the statute, it appears that a technical reading of Internal Revenue Code (IRC) Section 132 does not allow employees of a TWA/Northwest (TWA/NW) Airlines joint venture (PARS) tax-free standby travel. During consideration of the Technical Corrections Act of 1987, I intend to offer an amendment to correct this anomaly.

As a result of IRC Section 132, the long-time practice of airlines giving space-available transportation to their employees and treating this as a nontaxable fringe benefit was ratified. As originally passed in the Tax Reform Act of 1984, only employees of the airline who were personally engaged in the airline business were permitted this benefit on a tax-free basis.

In 1986, the Congress changed the law retroactively to allow this tax-free benefit to employees of corporations who performed airline-related services to airlines which were part of the same affiliated group. An affiliated group exists to the extent one corporation owns at least 80% in the other corporation or corporations.

Due to its relatively small size in relation to the major carriers, TWA sold one-half interest in its PARS CRS to Northwest because it believed that it, alone, could not compete against the CRS's of the megacarriers. Unfortunately, the sale of one-half interest means that the PARS operations cannot be considered as being part of either the TWA or Northwest consolidated groups and, hence, the employees are not eligible for tax-free, space-available travel.

The TWA/NW partnership is an attempt by these carriers to institute a neutral industry computerized reservations system. PARS employees who perform the same services and functions as employees of the other systems would not be entitled to the same tax treatment of their fringe benefits because of the difference in their choice of business forms. If the technical correction is not made, they would be faced with a situation of dissimilar tax treatment for entities based solely on their business form.

This results from the fact that, although qualified affiliates of airlines which perform airline-related services are eligible for this benefit, qualified affiliates are defined as corporations, at least 80% owned by the same affiliated group which includes an airline. The PARS partnership flunks this definition on two counts; it is a partnership rather than a corporation, and it is less than 80% owned by any one affiliated group, which includes an airline.

The partnership should not be handicapped in its efforts to overtake the industry leaders by a tax provision which prevents it from giving its employees the same benefits received by employees of the industry leaders.

American Airlines (American) is the nation's third largest (14% market share) and most profitable airline(1986 profit of $249 million); American's "Sabre" CRS is the world's largest with 38% of the domestic market. In 1986, the Sabre system generated revenues of $384 million and showed operating profits of $122 million. Since Sabre is operated as a division of American, its employees have the right to tax-free, space-available travel on American and other airlines with which American has reciprocal arrangements.

United Airlines (United) is the country's second largest airline (16% market share) and operates the Apollo CRS, which is the nation's second largest with 30% of the domestic CRS market. Although some industry estimates are that Apollo's 1987 gross revenues will be $350 million and its operating profit $70 million, former Chairman Ferris stated that Apollo's 1987 profit may reach $100 million. Currently, Apollo is operated as a division of United and, as airline employees, United's CRS employees have the right to tax-free, space-available travel on United and other airlines with which United has reciprocal arrangements. Even if United transfers its Apollo to a sister company as planned, since these employees will perform airline services for an airline n the same affiliated group, they will still have the same privileges.

The Texas Air Group, consisting of Eastern Airlines (Eastern) and Continental Airlines (Continental), is the nation's largest with 19% of the domestic market. By combining the formerly fourth largest CRS of Eastern with the smaller CRS capability of Continental, Texas Air's System One is now the nation's third largest CRS with 15% of the domestic market. Due to the advantages of being tied into the world's largest carrier, it is a threat to the current market dominance of Apollo and Sabre. System One is operated by a separate corporation, owned like its sister corporation, Continental and Eastern, by Texas Air Corporation. System One employees, as employees who perform airline-related services to airlines that are members of the same affiliated group, have the right to tax-free, space-available travel on both Eastern and Continental.

Delta Airlines (Delta), the nation's fourth largest (12% market share), and the nation's second most profitable with 1986 earnings of $194 million, operates a CRS called DATAS II. This system is the fifth largest in the country, with a 7% market share. Since the employees who operate the system are directly employed by Delta, they have the right to tax-free, space-available travel on Delta and The other airlines with which Delta has reciprocal arrangements.

In order to compete with largest and financially stronger carriers in the CRS business, TWA sold one-half interest in its PARS system to Northwest, a carrier which did not have a CRS. TWA and Northwest believe that by mutually supporting the same CRS, they will have the size and financial capability of competing with the megacarriers. Unfortunately, this combining of forces deprives them of the ability to offer their CRS employees with a valuable fringe benefit enjoyed by the employees of PARS's competition, i.e., tax-free, space-available travel. Due to the joint ownership of PARS, its employees can never be part of any affiliated group that owns an airline. In addition, even if one airline owned 80% of the partnership, the employees still would not be eligible since the qualified affiliate rule, as drafted, only applies to corporations.

This problems can be rectified by inserting the following language at the end of existing IRC Section 132(h)(d)(D):

> ...except that if airline related services are furnished by an entity which is wholly owned by more than one affiliated group, each of which affiliated group includes an airline, then such an entity will be considered a qualified affiliate of said airlines.

The proposed language taxes into consideration the sale of partnership interest in the PARS system to other airlines and will entitle PARS employees to tax-free, space-available transportation so long as the partnerships are solely owned by airlines. The suggested legislation has the added benefit of allowing the same benefit to other joint ventures formed either as corporations or partnerships which smaller airlines may organize to enable them to compete on a more equal basis with the new megacarriers.

I believe that the current tax law, which enables stronger rivals to give their employees a benefit that the TWA/NW joint venture is unable to give, was unintended and should be corrected.

In advance, thank you for your attention to this matter.

Yours very truly,

Richard A. Gephardt

Section 1879

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July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
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1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill -
Provisions on Stripped Tax-Exempt Bonds

Dear Mr. Leonard:

The Technical Corrections Bill recently introduced in Congress to amend the Tax Reform Act of 1986 contains certain revisions to Section 1286(d) of the Internal Revenue Code that governs the tax treatment applicable to holders of stripped tax-exempt coupons or bonds. The proposed amendment, if adopted unchanged, has the potential to adversely affect all persons investing in such stripped coupons and bonds.

Under current law, investors who purchase stripped tax-exempt obligations in the secondary market at a yield in excess of the yield at which the unstripped bonds were originally issued are not required to recognize any portion of the resulting market discount as taxable income (capital gains for most taxpayers) until they sell the bond or it matures or is redeemed. This tax treatment is consistent with the treatment of unstripped tax-exempt bonds purchased at a market discount.

Section 118(n)(4) of the Technical Corrections Bill, if adopted unchanged, would effectively change that treatment, but only for stripped tax-exempt obligations. Persons who purchase stripped coupons or bonds after June 10, 1987 at a yield in excess of the yield at which the unstripped bond had originally been issued would be required to treat a portion of the resulting market discount as though it were taxable original issue discount. The investor would be required to recognize as ordinary income each year a portion of the accretion of such market discount.

For example, if X stripped a tax-exempt bond originally issued at a yield of 10% and sold a stripped coupon at 8% to Y, the entire discount would be treated as tax-free original issue discount to Y. If Y later sold this stripped coupon to Z at a 9% yield, Z would treat the entire discount produced by the 9% yield as tax-free original issue discount. However, if Y had been forced to sell the stripped coupon at a yield of 11%, Z would treat the resulting discount as a combination of tax-free and taxable original issue discount. Each year Z would be required to include in his taxable income a proportionate share of the total accreted discount for the year. This taxable portion would be calculated by multiplying the total accreted discount by a fraction, the numerator of which would be 1% in this case and the denominator of which would be 11%.

We understand that the staff of the Congressional tax-writing committees looked at the Internal Revenue Code language governing stripped taxable obligations (e.g., stripped Treasury Bonds or STRIPS) and used that as a guide to draft the proposed amendment. Each purchaser of a STRIP is required to treat the entire discount at which he purchases his STRIP as taxable original issue discount, even though a significant portion of that discount may have arisen from market volatility. The staff apparently assumed that, to be consistent, market discount arising in stripped tax-exempt obligations should be treated similarly to that arising in STRIPS.

This treatment would obviously be inconsistent with the tax treatment for unstripped tax-exempt bonds purchased at a market discount. It would also unfairly penalize investors who purchased stripped coupons or bonds prior to June 10, 1987 and thereafter wish to sell such items. The potential for an exaggerated decrease in value in a down market would likely both drive up required market returns and limit severely the number and types of investors who would be interested in these instruments.

We ask that the Ways and Means Committee revise the language of Section 118(n)(4)(A) of the Technical Corrections Bill to eliminate this inconsistency in treatment between stripped and unstripped tax-exempt obligations. We suggest that subparagraph (ii) of the proposed Section 1286(d)(1)(A), recited in Section 118(n)(4)(A) of the Bill, be modified to substitute the words "market discount" for the term "original issue discount" in such subparagraph (ii).

Please call the undersigned if you have any questions or require additional information. We will be pleased to discuss this matter with you or your colleagues at your convenience.

Very truly yours,

Jack J. Johnson

Jack J. Johnson

Section 1883

PROPOSED TECHNICAL CORRECTION TO FICA AND FUTA COMMON PAYMASTER PROVISIONS IN CODE §§ 3121(s) and 3306(p)

Background

Pursuant to the Federal Insurance Contributions Act ("FICA"), an excise tax is imposed on every employer with respect to each individual in his employ. The tax imposed is a percentage (currently 7.15%) of the base amount of wages paid to the employee (current $43,800). In general, when the same individual is employed by two or more employers, each is subject to the FICA tax on the base wages of the individual. The statute provides an exception where two or more related corporations concurrently employ the same individual and compensate him through a common paymaster which is one of the corporations. In such case, the tax is determined as though the individual has only one employer, the common paymaster. As a result, the tax is applied against only a single base amount of wages.

The common paymaster provisions of sections 3121(s) and 3306(p) were added to the Internal Revenue Code by the Social Security Amendments of 1977, Pub. L. No. 95-216, §§ 314(a), (c). The stated purpose of the provision was to eliminate the dual taxation that sometimes resulted from treating an employee as employed by more than one related corporation for purposes of employment taxes where the employee is paid by one of those corporations. The Senate Finance Committee report advances no policy reason for limiting the common paymaster provision to related corporations in its brief discussion of this provision. Apparently, the Committee simply did not focus on the common paymaster problem in the context of related entities other than corporations. S. Rep. No. 572, 95th Cong., 1st Sess. (1977), reprinted in 1978-1 C.B. 485, 486.

Proposed Technical Correction for Partnerships

The common paymaster rule of section 3121(s) of the Internal Revenue Code would be expanded to include partnerships and affiliated corporations. The rule would be available in the case of a corporation and a related partnership where the same persons own, directly or indirectly, more than 50 percent in value of the corporation's outstanding stock and more than 50 percent of the capital or profits interest in the partnership. A corresponding change would be made to the common paymaster rule of section 3306(p) of the Code to provide comparable treatment in the case of federal unemployment (FUTA) taxes.

The following language would be added to sections 3121(s) and 3306(p) of the Internal Revenue Code of 1986 (relating to concurrent employment by two or more employers) at the end of each section:

> For purposes of this section, a corporation and a partnership shall be deemed to be related corporations if the same persons own, directly or indirectly, (1) more than 50 percent in value of the outstanding stock of the corporation, and (2) more than 50 percent of the capital interest, or the profits interest, in the partnership.

Reasons for Amendment

It is unfair to require different organizational entities in an affiliated group each to pay the full amount of the FICA tax with respect to the same individual simply because he performs services for more than one entity in the group. This amounts to double taxation of the group.

Current section 3121(s) constitutes recognition that double taxation of an affiliated group is inappropriate and undesirable. Yet this provision unfairly discriminates against partnerships by failing to provide a mechanism similar to that available to related corporations to avoid double taxation of an affiliated group.

The exclusion of partnerships from the exception for affiliated groups is inconsistent with other provisions of FICA. For example, section 3121(l), adopted as part of the 1983 Social Security Act Amendments, permits extension of the benefits of FICA to employees of a foreign affiliate of an "American employer," which is defined in section 3121(h) to include individuals, partnerships, and trusts, as well as corporations.

The filing of consolidated returns is not a prerequisite to application of current section 3121(s) to related corporations. Related corporations are defined in regulations to include 50% controlled corporations, or corporations with 50% or more common directors or officers, or 30% or more concurrent employees. The proposed 50% ownership rule in the related partnership-corporation situation thus tracks the existing rules for related corporations.

Supplemental Information

This statement is submitted by John E. Chapoton and Christine L. Vaughn of Vinson & Elkins, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of Goldman, Sachs & Co.

July 17, 1987

Section 1895

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July 10, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987: COBRA Amendment

Dear Mr. Leonard:

I am writing to suggest that a technical correction be made to a provision of the Internal Revenue Code added by COBRA and subsequently amended by the Tax Reform Act of 1986. Specifically, I would suggest that Section 162(k) of the Code, which requires that group health plans meet certain continuation coverage requirements, be modified in a manner consistent with Sections 4(b)(4) and 607 of ERISA to except from its application any plan maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens. Such a modification could be made by amending Section 118(q)(7) of the Technical Corrections Bill of 1987 so as to delete Section 162(k)(7)(B)(iii) of the Code and insert in lieu thereof the language contained in Section 4(b)(4) of ERISA.

As a policy matter, the continuation coverage requirements set forth under Section 162(k) of the Code should be consistent with the continuation coverage requirements set forth under Sections 601 through 607 of ERISA. Pursuant to Section 4(b)(4) of ERISA, the continuation coverage requirements set forth under Sections 601 through 607 of ERISA do not apply to any plan "maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens."

As currently worded, the continuation coverage rules under Section 162(k) of the Code operate under a different rule and appear to require that continuation coverage be provided by a non-U.S. company to any employee who is a U.S. citizen or who receives from his or her employer any U.S.-source earned income, even though the employee is a participant in a foreign medical plan, none of the other participants in which are U.S. citizens or receive U.S.-source income. Failure to comply with this requirement, would mean (assuming certain technical corrections are adopted) that any plan maintained by any U.S. company in the same controlled group as the non-U.S. employer would be deemed to have failed to meet the Section 162(k) requirements, with the attendant severely adverse tax consequences.

Given the multinational nature of many U.S. corporations and the increasing frequency with which U.S. corporations are acquiring foreign corporations and recognizing that the foreign company probably will be unaware of the terms and sanctions of COBRA or that any United States nationals are working for them, it is virtually certain that the terms of the foreign plan will not comply with COBRA requirements. Since Section 162(k)(7)(b)(iii) does not exclude from coverage plans maintained outside of the United States, the result of noncompliance on the part of the foreign plan with respect to even a single U.S. citizen would be that the U.S. employer would lose all deductions for contributions to any group health plan and in addition, the highly compensated employees of the U.S. employer would be unable to exclude from income any employer contributions to health or accident plans made on their behalf.

It is respectfully submitted that such a result reflects not only poor tax policy but also poor economic policy. It may not only deter the growth of U.S. companies but also cause them to revise the types of health care coverage that they provide to their U.S. employees. In addition, it is certain to lead to noncompliance on a massive scale.

I would be pleased to discuss this issue with you further at your request.

Very truly yours,

James P. Lawton

James P. Lawton

Morgan Guaranty Trust Company of New York
23 Wall Street, New York, NY 10015

Gail C. Wasserman
Vice President
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The
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August 13, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Re: Technical Corrections Bill of 1987: COBRA Amendment

It has been brought to our attention that in the current COBRA tax rules (specifically, IRC Section 162(k)(7)(B)(iii)) there is a requirement that multinational corporations extend the COBRA - continuation of health care benefit provisions to employees of foreign affiliates who are U.S. citizens or who have any U.S. source earned income from the employer.

This requirement substantially adds to the burden of administering the current COBRA health care provisions, and is of great concern to us given the severe penalties for noncompliance under the proposed COBRA regulations.

We currently extend to all U.S. employees transferred overseas on temporary assignment (usually two to four years) the opportunity to continue to participate in the same benefit programs offered to employees based in the United States. The rationale for this practice is to ensure that no employee temporarily assigned abroad experience a shortfall in benefits relative to the coverage they enjoyed in the U.S. prior to that assignment. We extend, therefore, COBRA continuation rights to these employees.

We have two other groups of employees based overseas for whom we would have difficulty tracking terminations to ensure notification of COBRA rights:

> Our foreign offices may hire U.S. citizens locally — such as in Tokyo or London. Because these U.S. citizens are hired locally, they are offered the foreign office benefits program. It is appropriate for these employees to be enrolled in the local health care benefits program because that program is designed to accommodate the local health care delivery system. We currently maintain no information on who is enrolled in foreign office benefit programs because we have no ongoing adminstrative involvement with those programs.

> We have a few third country nationals (TCNs) who are assigned overseas, affiliated with foreign office benefits program, and whose home-base is other than the United States, but who are also green card holders or who have dual citizenship. It seems arbitrary to extend COBRA rights to these few TCNs when they have no association with the U.S. benefits program.

We respectfully request your staff to consider an amendment to the 1987 Technical Corrections Tax Bill that would delete entirely Section 162(k)(7)(B)(iii) or alter that same Section so that it addresses employees of foreign affiliates who are U.S. citizens, or who have any U.S. source earned income from the employer, and who are residing in the United States. Our emphasis on residence in the United States takes into consideration one of the stated purposes of the COBRA health care continuation provisions — that of reducing the amount of uncompensated care and the number of uninsured in our U.S. health care system.

Sincerely,

TECHNICAL CORRECTIONS RELATED TO TAX PROVISIONS IN OTHER LEGISLATION

Superfund Revenue Act of 1986 (TCA Section 201)

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July 9, 1987

BY HAND

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Technical Corrections Bill (H.R. 2636)
Section 210 (Superfund)

Dear Mr. Leonard:

On behalf of the International Business Machines Corporation, we urge a further technical correction to the Superfund Revenue Act of 1986 to deal with the manifest error of including section 78 "gross-up" in the Superfund base.

The Superfund Revenue Act imposed a new environmental tax generally based on corporate alternative minimum taxable income ("AMTI"). This tax is imposed even if the corporation is not otherwise subject to the alternative minimum tax. No credits are allowable.

Under section 78 of the Code, regular taxable income for a corporation claiming a foreign tax credit is increased by the amount of foreign taxes deemed paid in order accurately to compare U.S. and foreign tax rates for limitation purposes. The increase in income never increases U.S. tax by more than the credit allowed. The alternative tax also allows a credit (albeit limited to 90%), and the gross-up inclusion in AMTI remains appropriate for the purpose of minimum tax. The Superfund tax on the same base, however, allows no foreign tax credit. The effect of using AMTI in Superfund is to tax phantom foreign income never received in this country, a result that cannot be rationally defended. Moreover, it is generally agreed that using AMTI in Superfund discriminates unfairly against U.S. corporations with multinational operations versus U.S. corporations with only domestic operations.

Proposed Technical Correction

Section 59A(b) of the Internal Revenue Code of 1986 is amended by striking the period at the end thereof and adding the following language:

> "and, if the taxpayer chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for the taxable year, reduced by
>
> > (3) the amounts provided in the applicable paragraph of section 901(b), plus
> >
> > (4) the taxes deemed to have been paid under sections 902 and 960."

I will be pleased to answer any questions.

Very truly yours,

John B. Jones

John B. Jones, Jr.

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July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Rob:

On behalf of the Man-Made Fiber Producers Association, I am submitting comments relating to an omission in the Superfund Amendments and Reauthorization Act of 1986 (Public Law 99-499, "SARA"). The Man-Made Fiber Products Association is a trade association representing the manufacturers of more than 90% of the U.S. production of man-made fibers, filaments, and yarns. The needed correction would add three additional substances to the list of taxable substances in Section 4672 of the Internal Revenue Code of 1986 (the "Code").

Section 4672 of the Code lists toxic substances that are subject to tax. Under section 4672(a)(2) of the Code, substances shall be included in this list if taxable chemicals (as defined by Code section 4661) "constitute more than 50 percent of the weight of the materials used to produce such substance." Fifty substances are identified by Section 4672. At least three other qualifying substances, polyester, nylon 66 and polyacrylonitrile, however, were omitted.

Polyester is made primarily from xylene and ethylene, both taxable chemicals under section 4661 of the Code. Similarly, benzene, nitric acid, butadiene and hydrogen cyanide are ingredients used in the production of nylon 66. The third chemical, polyacrylonitrile is a polymer of acetonitrile which, in turn, is made from propylene and ammonia. As the table below indicates, taxable chemicals comprise a majority of the weight of all three substances.

Substance	Percent of Taxable Chemicals by Weight
Polyester	69%
Nylon 66	70%
Polyacrylonitrile	55%

The inclusion of polyester, nylon and polyacrylonitrile among the list of taxable substances in section 4672 would not only address the technical oversight caused by their omission, but would also fulfill the legislative intent of Congress to prevent U.S. manufacturers from being placed at a competitive disadvantage. In enacting SARA, Congress recognized that taxing toxic raw materials would adversely affect American producers by raising their costs of production. To address this imbalance between U.S. and foreign prices for goods produced from the list of taxable chemicals, a system of import duties and export credits was enacted. The inclusion of polyester, nylon and polyacrylonitrile among the list of taxable substances would restore the balance intended by Congress.

The proposed correction would tax imported polyester, nylon and polyacrylonitrile. In addition, American producers would receive a credit for these products that they export. As a result, a fairer and more balanced competitive position would be secured for U.S. manufacturers if this correction is adopted.

Thank you for this opportunity to comment on the technical corrections legislation. I would be happy to provide you or your staff with any additional material it may need.

Sincerely,

John J. Salmon

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July 22, 1987

Mr. Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Rob:

On Friday July 17, 1987, a proposed amendment to the Technical Corrections Act relating to the Superfund Reauthorization Act of 1986 was submitted on behalf of the Man-Made Fiber Producers Association (See attached). The submission suggests that three substances be added to the list of taxable substances identified in Section 4672 of the Internal Revenue Code. Our submission needs a minor clarification with regard to the substance Nylon.

Nylon 66 was identified as a qualifying substance that was omitted from Section 4672 of the Code. However, nylon 66 is but one of two nylon products that properly should be included in the Code. A second nylon product, Nylon 6, also deserves inclusion in Section 4672 based on its chemical composition.

Nylon 6 is made from benzene, ammonia, hydrogen and oxygen. The taxable chemicals (under Section 4661 of the Code) represent approximately 72% of the weight of nylon and a greater proportion of its value. Thus, in amending Section 4672 of the Code, it would be appropriate to individually identify both nylon 6 and nylon 66 as taxable substances.

Thank you for the opportunity to clarify our comment to the technical corrections legislation. Please contact me if you need further information.

Sincerely,

John J. Salmon

Marathon
Oil Company

Findlay, Ohio 45840
Telephone 419/422-2121

July 9, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

Re: HR 2636, the Technical Corrections Act of 1987

In the interest of simplifying the administration of the Superfund Revenue Act of 1986, I would propose the following addition to subsection 4611.(d)(2): "Where imported petroleum products are destined for delivery to a U.S. refinery, the U.S. refiner may assume liability for the tax and pay the tax upon receipt of the products at its U.S. refinery."

The current law prescribes an unnecessary dichotomy of tax incidence upon imported v. domestic crude. There's no revenue effect attendant to my proposal (perhaps 30-60 days later reporting) but it would simplify my accounting and provide I.R.S. the same or better audit trail to verify the tax has indeed been paid on the imported petroleum products (crude).

I enclose a brief paper explaining or rationalizing my proposal - "SUPERFUND PETROLEUM TAX, Incidence of Tax on Imported Crude Oil." You will note that strict compliance with the current statutory language can result in significantly higher carrying costs of foreign crude feedstocks in addition to the rate differential which is the subject of a GATT complaint. The principal purpose for conforming the tax incidence, however, is simply to enhance administration for us, our trading partners and the Service.

I will be happy to discuss this subject further with your staff, JCT or Treasury.

Very truly yours,

D. A. Beamer

SUPERFUND PETROLEUM TAX

Incidence of Tax on Imported Crude Oil

In order to standardize taxpayer compliance administration procedures and limit the number of Superfund tax collectors, API has suggested that incidence of the tax on imported crude be conformed to that on domestic crude; i.e, receipt at a U.S. refinery. Some observations and examples illustrating a rationale for that conformity follow.

Disposition of Imported Crude

1) Generally
    a) Processed at U.S. refinery

    b) Exported without processing

2) Possibly
    a) Purchased by U.S. for SPR

    b) Burned as boiler fuel?

    c) Asphaltic concrete for roads?

In fact, virtually all imported crude is refined. Exported crude is not subject to the tax, but the incongruous result of strict compliance with the present rule is that exported imported crude would be taxed as there is no credit or refund mechanism. Crude oil for refining in Montreal, Quebec, Canada enters the Portland Pipe Line system from tankers near Portland, Maine and traverses Maine, New Hampshire and Vermont enroute to Quebec. Query, is the import taxable? Probably not, assuming neither use nor storage of the crude intransit. On the other hand, Canadian crude enters the Interprovincial pipeline in Alberta, Canada destined for Chicago or Detroit refineries. It moves from Interprovincial to the Lakehead system in northern Minnesota and then spends another week flowing to Chicago or Detroit.

The tax technically would be due at some Customs point in Minnesota even though the practical importation doesn't occur until removal from the pipeline at the refinery, which is where we (Marathon) are accruing the tax.

Normal Industry Operational and Transactional Examples

1) Taxpayer A imports 1M bbl. at LOOP (south Louisiana), holds it for 20 days in caverns there and delivers it to Detroit, MI refinery for processing. Taxpayer A has paid $117,000 tax 30 days before the crude was effectively imported; i.e., receipt at refinery.

    Taxpayer B delivers 1M bbl. domestic crude from Wyoming 30 days after its production and storage in lease tanks or pipeline terminals. Taxpayer B pays $82,000 tax only after receipt at the refinery.

2) Taxpayer A imports 1M bbl. and delivers to Taxpayer B Gulf Coast refinery. Taxpayer B delivers to Taxpayer A's inland refinery 1M bbl. domestic crude at 50k per day.

    Taxpayer A owes $117,000 tax on imported crude and $41,000 tax on domestic crude (10 days @ 50k @ $.082) before Taxpayer B owes any tax, even though they each start running the respective crudes on the same day. Imported crude may, in fact, be exchanged more than once before receipt at a refinery.

3) Domestic refiners account for crude received at refineries and can segregate domestic v. foreign to accommodate accrual at differential rates. What is not implicit in our present accounting is any distinction between tax-paid receipts and untaxed receipts.

    (If we are importer of record, we must accrue and pay tax - if another refiner or importer has charged us the tax, we don't need to accrue and pay. The difference in incidence of tax causes us a manual review of all crude oil invoices each month, as opposed to simply multiplying total receipts volume by rate and depositing with IRS.)

Suggestion

For ease of administration by both IRS and refiners, simply add to subsection 4611.(d)(2) "Where imported petroleum products are destined for delivery to a U.S. refinery, the U.S. refiner may assume liability for the tax and pay the tax upon receipt of the products at the U.S. refinery."

Harbor Maintenance Revenue Act of 1986 (TCA Section 202)

COMMENTS OF CONGRESSMAN

BEN BLAZ

GUAM

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I SUPPORT TITLE II, SUBTITLE B OF THE TECHNICAL CORRECTIONS ACT OF 1987 WHICH WILL EXEMPT CARGO SHIPPED BETWEEN U.S. POSSESSIONS, BETWEEN U.S. POSSESSIONS AND ALASKA OR HAWAII AND BETWEEN ALASKA AND HAWAII. THIS TECHNICAL CORRECTION IS NEEDED TO CARRY OUT THE INTENT OF CONGRESS NOT TO SUBJECT INTER-ISLAND SHIPPING TO THE PORT USERS FEE. THE HOUSE WAYS AND MEANS COMMITTEE CONTEMPLATED AN EXEMPTION FOR INTER-ISLAND CARGO. HOUSE REPORT 99-251, PART III, AT PAGE 9 CLEARLY INDICATES THAT CONGRESS INTENDED FOR SHIPPING AMONG THE INSULAR POSSESSIONS TO REMAIN UNAFFECTED BY THIS USER FEE. THIS SHIPPING WAS LATER INADVERTENTLY SUBJECTED TO THE PORT USERS FEE DURING THE CONFERENCE COMMITTEE ON THE HARBOR MAINTENANCE REVENUE ACT OF 1986.

OWING TO THE DISPROPORTIONATE DEPENDENCE OF THE ISLAND TERRITORIES ON SHIPPING THIS USERS FEE HAS ALREADY HAD AN ADVERSE EFFECT ON THE ECONOMY OF THE REGION. SHIPMENTS OF GOODS THROUGH HAWAII TO THE INSULAR POSSESSIONS AND FREELY ASSOCIATED STATES HAVE INCREASED IN COST. THIS ADDED COST INHIBITS THE GROWTH OF THIS REGION WHICH IS JUST BEGINNING TO RISE FROM MANY DECADES OF ECONOMIC INERTIA. SINCE NONE OF THE INSULAR POSSESSIONS HAVE SIGNIFICANT NATURAL RESOURCES, TRADE AND SHIPPING ARE VITAL TO THE CREATION AND SUSTENANCE OF ANY ECONOMY IN THE PACIFIC. UNLIKE THE MAINLAND THERE ARE NO ALTERNATIVES TO SHIPPING. THE IMPACT OF THIS FEE HAS BEEN IMMEDIATE AND SUBSTANTIAL. FURTHER, THE LEVY ON PASSENGERS WILL STIFLE THE POTENTIAL FOR CRUISE SHIP TRAFFIC -- A LONG HOPED-FOR, VITAL COMPONENT OF OUR TOURISM INDUSTRY. THE PORT USERS FEE WILL ALSO DISCRIMINATE AGAINST AMERICAN GOODS IN FAVOR OF FOREIGN GOODS SHIPPED TO THE INSULAR AREAS VIA FOREIGN SHIPPING. IN AN ERA WHEN THE U.S. MUST PROMOTE THE SALES OF ITS OWN INDUSTRIAL PRODUCTION THE PORT USERS FEE WILL WORK AGAINST THOSE VERY SALES IN THE AMERICAN PACIFIC. THIS MAKES NO ECONOMIC SENSE EITHER FOR THE ISLANDS OR FOR THE MAINLAND UNITED STATES. THE PROPOSED TECHNICAL CORRECTION WILL REMEDY THIS INCONSISTENCY BETWEEN THE INTENT OF CONGRESS AND ECONOMIC SENSE AND THE WAY THE LAW ACTUALLY READS.

FOR YOUR INFORMATION I HASTEN TO ADD THAT THE NINETEENTH GUAM LEGISLATURE AND THE ASSOCIATION OF PACIFIC ISLAND LEGISLATURES HAVE ADOPTED RESOLUTIONS AGAINST THE IMPLEMENTATION OF THE PORT USER FEE ON INTER-ISLAND SHIPPING AND IN FAVOR OF THIS TECHNICAL CORRECTION. I JOIN THEM IN THE EFFORT TO SEE THIS UNFORTUNATE OVERSIGHT CORRECTED.

I THANK YOU FOR YOUR TIME AND INTEREST.

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July 10, 1987

By Hand Delivery

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: H.R. 2636, The Technical Corrections Act of 1987

Dear Mr. Leonard:

We are writing on behalf of seven conferences of ocean carriers to support the inclusion in H.R. 2636, The Technical Corrections Act of 1987, of a provision submitted to the Committee by Representative Helen D. Bentley. That provision would clarify the scope of the Harbor Maintenance Tax imposed pursuant to Sections 4461 and 4462 of the Internal Revenue Code of 1986. The conferences we represent are the Asia North America Eastbound Rate Agreement, The "8900" Lines, Greece/United States Atlantic and Gulf Conference, Israel Eastbound Conference, Israel Westbound Conference, Mediterranean North Pacific Coast Freight Conference, and the South Europe/U.S.A. Freight Conference (hereinafter referred to as the "Conferences"). The Conferences include some of the largest ocean carrier companies in the world and serve trades in the foreign commerce of the United States to or from the Far East, Europe and the Middle East.

Representative Bentley's proposed provision would clarify that the Harbor Maintenance Tax, which was included in the Internal Revenue Code by the Harbor Maintenance Revenue Act of 1986, will be imposed only once on cargo entering or leaving the United States in a continuous transportation by a single shipper. We believe, as does Representative Bentley, that this provision reflects the original intent of Congress in enacting the Harbor Maintenance Tax last year. However, the U.S. Customs Service, in interim regulations implementing the Harbor Maintenance Tax, has interpreted it in such a way as to impose the tax twice on certain cargo which is transshipped between U.S. ports on its way to or from foreign ports or points. The Conferences have submitted comments to the Customs Service urging that these interim regulations be modified to reflect the original intent of Congress. A copy of our comments is attached hereto, and we refer you to them for a more detailed discussion of this issue.

Representative Bentley's proposed provision is very appropriately included in the Technical Corrections Act. The Chairman of the Committee has indicated that the purpose of the Act is to make corrections to the Tax Reform Act of 1986 and other tax legislation enacted during the 99th Congress, including the Harbor Maintenance Revenue Act of 1986. Representative Bentley's provision is designed to do precisely that --*i.e.*, clarify the Harbor Maintenance Revenue Act of 1986, which has been misinterpreted by the U.S. Customs Service.

For these reasons, the Conferences urge the Committee to include Representative Bentley's provision in the Technical Corrections Act of 1987.

Sincerely,

Marc J Fink

Marc J. Fink
Counsel for:
Asia North America Eastbound
  Rate Agreement
The "8900" Lines
Greece/United States Atlantic
  and Gulf Conference
Israel Eastbound Conference
Israel Westbound Conference
Mediterranean North Pacific
  Coast Freight Conference
South Europe/U.S.A. Freight
  Conference

NOTE: Several of the concerns represented herein are foreign-based; Dow, Lohnes & Albertson has registered with the Department of Justice pursuant to the Foreign Agents Registration Act with respect to its representation of foreign concerns.

Before The
UNITED STATES CUSTOMS SERVICE
UNITED STATES DEPARTMENT OF THE TREASURY

COMMENTS OF OCEAN CARRIER CONFERENCES ON T.D. 87-44 -- INTERIM REGULATIONS IMPOSING HARBOR MAINTENANCE FEES

These comments are filed on behalf of seven conferences of ocean carriers [1] with respect to the Customs Service's interim regulations implementing the .04% harbor maintenance fee authorized by the Water Resources Development Act of 1986 ("the Act"). The interim regulations were published at 52 F.R. 10198 on March 30, 1987, and went into effect on April 1, 1987. These regulations are, however, only interim in nature and the Customs Service has invited comments on them before final regulations are adopted.

The Conferences wish to address only one aspect of the interim regulations which they believe is unfair and contrary to the spirit and intent of the Act. Through the combination of sections 24.24(a), 24.24(e), and 24.24(e)(2) of the interim regulations, it appears that in certain instances the same cargo could be taxed twice on the same voyage. The possibility of such double taxation should be eliminated.

Specifically, cargo imported into the United States is often "transshipped" by water to its U.S. destination port via another U.S. port -- e.g., it arrives at New York and is then moved by another vessel to Boston, where it is discharged to the consignee. [2] Under the interim regulations as presently written, if the same vessel were used in the foreign and the domestic transportation, this cargo would only be taxed once, at Boston. See § 24.24(d)(2). However, if a different vessel were used for the transshipment, it appears that that same cargo would be subject to the tax twice -- once at New York and again at Boston. See § 2424(e)(1); (3).

---

[1] The conferences filing these comments are the Asia North America Eastbound Rate Agreement, The "8900" Lines, Greece/United States Atlantic and Gulf Conference, Israel Eastbound Conference, Israel Westbound Conference, Mediterranean North Pacific Coast Freight Conference, and the South Europe/U.S.A. Freight Conference (hereinafter referred to as the "Conferences").

[2] The same scenario can occur in reverse for export cargo -- i.e., under the example given, cargo could be loaded at Boston and carried to New York for shipment overseas.

The Conferences submit that such treatment is arbitrary and unfair for two reasons. First, it is discriminatory. The interim regulations would tax a shipment twice simply because the cargo changed vessels at a U.S. transshipment port. However, under the regulations, an identical shipment which also passed through another U.S. port on the way to its ultimate destination would only be taxed once if the U.S. portion of the carriage happened to be by the same vessel. This would apparently be the case even if, as is sometimes done, that cargo were unloaded at the first U.S. port and reloaded onto the same vessel. This is a wholly arbitrary distinction because it taxes two identicla shipments differently. The two shipments described above would touch the same number of U.S. ports and use U.S. ports to precisely the same extent. Congress' purpose was to impose the tax on port use and where, as in the above example, two shipments use ports to the same extent, they should be taxed the same.

The interim regualtions are also unfair because they would tax shipments twice even though there is only one shipper, one consignee, one bill of lading, and one load of cargo. In the above example, if a U.S. consignee imports a load of cargo from Europe to Boston via New York, he would have to pay the tax twice on the same shipment if the cargo is transferred to a different vessel in New York. This is contrary to the clear intent of the Act which it ostensibly implements.

The Act is oriented towards cargo shipments and port use. The tax is tied to the value of the cargo. The tax is to be paid "in the case of cargo to be exported from the United States at the time of loading", and "in any other case, at the time of unloading". 36 U.S.C. § 4461(c)(2). These provisions demonstrate that Congress intended "cargo" to be taxed at some point during shipment. In furtherance of this intent, Congress included section 4461(g) in the Act, which is entitled "Tax Imposed Only Once". This section provides that the same cargo will only be subject to tax once during a shipment. [3] Accordingly, the double tax imposed by the interim regulations contravenes the clear intent of Congress.

That Custom's interpretation of the statute is erroneous on this point is demonstrated by the fact that shortly after the interim regulations were issued on April 29, 1987, Congresswoman Bentley, a member of the House Merchant Marine and Fisheries Committee and a former chairperson of the Federal Maritime Commission introduced legislation to correct Customs' interpretation. The proposed bill, H.R. 2202, a copy of which is attached hereto, is expressly designed "to provide that the harbor maintenance tax shall apply only once to cargo entering the United States in a continuous transportation by a single shipper." To that end, the bill provides that the tax will only be paid once for a shipment if the shipper is the same throughout and the transportation is continuous to the ultimate destination.

---

[3] Although section 4461(g) specifically refers to shipments via the same vessel, there is no indication it meant to permit double taxation where a different vessel is used.

In a statement issued when the bill was introduced, Representative Bentley made clear that H.R. 2202 is intended to clarify the meaning of the existing law:

> H.R. 6 did specify that no single shipper would be subject to the same user fee twice or more on the same cargo.
>
> Interim regulations issued by U.S. Customs are in violation of H.R. 6. The temporary regulations provided that cargo between U.S. ports is subject to a cargo fee at each unloading, which specifically is in opposition to H.R. 6.

CONCLUSION

For the reasons stated above, the Conferences urge Customs to modify the interim regulations to make clear that a shipper is only liable for the Harbor Maintenance Tax once with respect to a continuous shipment to and from the United States. This is the only fair and reasonable interpretation and is the only interpretation which will prevent discrimination among similarly situated shippers and consignees.

Respectfully submitted,

Marc J. Fink

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Congress of the United States
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COMMITTEE ON
PUBLIC WORKS AND
TRANSPORTATION
SUBCOMMITTEES
WATER RESOURCES
ECONOMIC DEVELOPMENT

COMMITTEE ON
MERCHANT MARINE
AND FISHERIES
SUBCOMMITTEES
MERCHANT MARINE
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CONTINENTAL SHELF
OVERSIGHT AND INVESTIGATIONS

SELECT COMMITTEE ON AGING
SUBCOMMITTEE ON RETIREMENT
INCOME AND EMPLOYMENT
TASK FORCE ON WOMEN
AND SOCIAL SECURITY

June 22, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We are writing to register our comments with the Committee on Ways and Means concerning the need to have amending language designed to eliminate dual harbor fees under the Water Resources Development Act of 1986. This amendment should be included in the Technical Corrections Act of 1987, H.R. 2636, during committee markup of the legislation.

It is our understanding that the committee will soon markup H.R. 2636 and an amendment should be made in order and passed to accomplish this objective. Congressional committee staff members, Ms. Janice Mays, Mr. Donald Longano and Ms. Barbara Groves, have recommended that an amendment to H.R. 2636 would correct the problem of a dual tax on the shipping industry. Staff members handling tax issues at the U.S. Department of the Treasury have also been informed of this amending language.

The amending language to be offered in markup of H.R. 2636 is designed to amend the Internal Revenue Code of 1986 so that under the revenue provisions of the Harbor Maintenance Fee, a shipper shall not be forced to pay a user fee tax twice on the same cargo. This language is necessary to amend the IRS Code of 1986 and state that the harbor maintenance tax shall apply only once to cargo entering and exiting the United States in a continuous transportation by a single shipper. This will prevent the same shipper from being subject to the same fee on the same cargo more than once.

We in no way are advocating freeing the shipper from paying his fair share to help develop the harbor. It is only fitting that every user of the harbor pay its share but not more than is required or justified. We support and worked in committee to include the agreed upon cost sharing formula between the federal government and state and local beneficiaries to fund harbor development. The 0.04% ad valorem fee is also a necessary revenue provision in the Water Resources Development Act of 1986.

However, our objections are not a result of Customs collecting an ad valorem fee of 0.04% but rather mutiple fees or taxes for the same cargo. This dual and sometimes triple taxation of cargo places an undue burden on the shipping industry and is in direct opposition to congressional intent. Congress has a history of passing legislation that is designed to tax only once. The unfair practice of a dual taxation has rarely if ever been the will of Congress.

Congress passed legislation that established a gas tax to be used to help finance the construction of our nation's highway systems. This gasoline tax is levied only once. The imposition of the gasoline tax (26 USC 4081-4083) mandates by law that the tax can only be levied once and not subject to dual or multiple fees. This law provides a clear precedent for Congress passing legislation that imposes a user fee to be collected once when using the revenue to help construct harbor development. Therefore, the 0.04% ad valorem harbor maintenance fee should be imposed only once and not levied twice or multiple times.

Dual fees on transshipped cargo causes problems for our nation's ports and will continue to reduce business. In the Port of Baltimore, ships that enter the port must first unload cargo in the harbor and then place it on a barge to be transported further up the Chesapeake and Delaware Canal. At each unloading the cargo is subject to an ad valorem fee. This has the potential of driving business away from the port and costing millions of dollars worth of business. Other prominent domestic ports such as the Port of Houston, the Port of Boston, and ports in Alaska are subject to similar situations.

U.S. Customs issued interim regulations on March 30, 1987 (Federal Register, Vol. 52, No. 62, pp. 10198-10203) outlining provisions which require that the 0.04% ad valorem fee be levied on the shipper at each unloading of cargo. Our proposed legislative language would ensure that the ad valorem fee would apply only once to export and import cargo of the United States in a continuous transportation by a single shipper. This amendment would eliminate dual and multiple fees on the same cargo.

We request that this legislative language be made in order for consideration by the Committee on Ways and Means during markup of the Technical Corrections Act of 1987, H.R. 2636. Attached with our comments is a copy of the proposed legislative language.

Sincerely,

Helen Delich Bentley
Helen Delich Bentley
Member of Congress

Bill Archer
Bill Archer
Member of Congress

SECTION 1. HARBOR MAINTENANCE TAX TO APPLY ONLY ONCE TO CARGO ENTERING OR LEAVING THE UNITED STATES IN A CONTINUOUS TRANSPORTATION BY A SINGLE SHIPPER.

(a) IN GENERAL.--Subsection (g) of section 4462 of the Internal Revenue Code of 1986 (relating to definitions and special rules for harbor maintenance tax) is amended by adding at the end thereof the following new paragraph:

``(3) CARGO ENTERING OR LEAVING THE UNITED STATES.--

``(A) IMPORTS.--In the case of cargo which entered the United States and on which tax under section 4461(a) was paid by the importer, no tax shall be imposed under such section on any subsequent loading or unloading of such cargo if--

``(i) the shipper of such cargo at the time of entry and at the time of such subsequent loading or unloading is the same, and

``(ii) such subsequent loading or unloading is in connection with the continuous transportation of such cargo to its ultimate destination in the United States.

``(B) EXPORTS.--In the case of cargo which is destined for export and on a loading or unloading of which tax was imposed under section 4461(a), no tax shall be imposed under such section on any subsequent loading or unloading of such cargo if--

``(i) the shipper of such cargo at the time such tax was imposed and at the time of such subsequent loading or unloading is the same, and

``(ii) such subsequent loading or unloading is in connection with the continuous transportation of such cargo to its ultimate destination outside the United States.''

(b) EFFECTIVE DATE.--The amendment made by subsection (a) shall take effect as if included in the amendments made by section 1402 of the Harbor Maintenance Revenue Act of 1986.

Sea-Land Corporation

Suite 560 • National Place • 1331 Pennsylvania Avenue, N.W. • Washington, D.C. 20004 • (202) 783-1117

June 26, 1987

The Honorable Dan Rostenskowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

Sea-Land Corporation is pleased to submit comments on H.R. 2636, the Technical Corrections Act of 1987, pursuant to your request of June 10.

Sea-Land Corporation, a unit of CSX Corporation, is a world leader in international intermodal freight transportation and related trade services. Our principal operating subsidiary, Sea-Land Service, Inc., today operates a fleet of 29 U.S.-flag containerships which serve both domestic and foreign commerce.

As our business depends directly on the free flow of cargo over our Nation's ports, we followed with keen interest the debate over the Water Resources and Development Act of 1986. As you know, the Ways and Means Committee approved one title of that new law which authorized a .04 percent ad valorem fee on import/export cargo for the purpose of funding a portion of the costs associated with operating and maintaining ports and waterways. This fee is to be paid by the shipper of the cargo directly to the federal government.

It since has come to our attention that this fee may be applied twice to cargo which is relayed over a second port en route to its final destination if that cargo is transferred to a different vessel at the relay port. Representative Helen Bentley has proposed legislation to correct this problem, and Sea-Land Corporation wishes to strongly endorse her effort.

Sea-Land, as well as many other ocean carriers serving the U.S. foreign commerce, has employed for some years a relay system between U.S. ports in order to provide the fastest, most economical service possible to our customers. We believe our industry has been encouraged by various government policies to develop and offer this kind of innovative transportation option. Yet, if the ad valorem fee cited above is imposed twice on cargo utilizing this service, it could jeopardize the service to the ultimate detriment of the U.S. consumer and exporter. Moreover, we believe it is inherently unfair to ask a shipper, whether an importer or an exporter, to pay the same tax twice on the same cargo.

Representative Bentley's legislative solution would make clear the ad valorem fee should apply only once to import/export cargo moving on a through bill of lading, whether or not the cargo is relayed on a different vessel for the final leg of its journey. It is our understanding that she intends to ask the Ways and Means Committee to adopt her language as an amendment to the Technical Corrections Act when that measure is considered at mark-up. We urge you to respond positively. To allow this dual fee to stand would be to mitigate many of the advantages of a transportation system which is designed and in place to promote American commerce.

If we can answer any additional questions about our service or our views on this issue, I hope you will not hesitate to contact me.

Sincerely,

Rebecca J. Berg

Rebecca J. Berg
Director, Federal Public Affairs

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EDWARD P. WALSH
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July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

On behalf of the Transportation Institute, a non-profit association representing over 140 U.S.-flag vessel operators engaged in the nation's foreign and domestic shipping trades, I am writing to urge the Committee's support during its markup of H.R. 2636, the Technical Corrections Act of 1987, for amendatory language suggested by Representative Bentley and Representative Archer, designed to eliminate multiple imposition of Harbor Maintenance Fees under the Water Resources Development Act of 1986.

An important component of the transportation network offered by U.S.-flag companies is the utilization of cost effective "feeder" services used to distribute cargo to a wider range of ports without the need for numerous linehaul vessel calls. Under such an arrangement, a linehaul vessel would call at a major U.S. port and unload cargo subject to the fee destined for that port and also unload cargo which would be reloaded on barges which then carry the cargo to other ports for movement to interior destinations. This procedure is followed when the cargo volume bound for the feeder ports is not sufficient to warrant an expensive port call from the linehaul vessel.

Other vessels utilizing LASH (Lighter Aboard Ship) technology, carry cargo laden barges in the hold of the linehaul vessel. Those barges are offloaded and towed to feeder ports in a given coastal range. In this case also, the economics of the cargo volumes do not justify separate port calls by the linehaul vessel.

In each of these cases, the cargo which is transported via feeder services is subjected to the fee at the original port of unloading. Current U.S. Customs regulatory practice, however, unjustly imposes the fee a second time when the cargo is unloaded from the feeder/LASH barges at the second port.

This practice is contrary to the intent of Congress as expressed in House Report 99-251 (p517) which clearly expressed that the multiple imposition of the fee was "specifically prohibited." The added expense and onerous paperwork burden created by the multiple imposition of the fee fosters a climate in which a shipper will seek landbased modes to "feed" cargo from a linehaul port, thereby placing waterborne carriers under an artificially imposed competitive disadvantage.

The amending language merely clarifies the intent of the Congress in passing the Water Resources Development Act of 1986 that cargo would be assessed a fee only once. The interim regulations issued by the Customs Service contradict the intent of the Act. This amendment, formulated by Representatives Bentley and Archer, would eliminate the potential for multiple taxation on cargo by ensuring that the fee would apply only once to export and import cargo of the United States in a continuous movement by a single shipper.

We urge the Committee to adopt the language submitted by Representatives Bentley and Archer as a justifiable and necessary technical correction during Ways and Means markup of H.R. 2636.

Sincerely,

James L. Henry

James L. Henry

Omnibus Budget Reconciliation Act of 1986 (TCA Section 203)

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July 16, 1987

BY HAND

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: §203(b) of H.R. 2636, The Technical Corrections Act of 1987

Dear Rob:

Section 203(b) of H.R. 2636, referred to above, amends Section 8011 of the Omnibus Budget Reconciliation Act of 1986. We are writing to urge a further modification of §8011.

In 1986 Section 8011, referred to above, amended Section 5061(d)(2) of the Internal Revenue Code to require that a Foreign Trade Zone be treated as if it were a customs bonded warehouse where bottled imported distilled spirits, wine and beer are brought into a zone.

Prior to enactment of P.L. 99-509, importers were permitted to temporarily house imported bottled distilled spirits, wine and beer in foreign trade zones and then to transfer such goods to customs bonded warehouses without treating such transfers as entries into the Customs Territory of the United States. The new law requires the payment of excise tax on removal of product from the first customs bonded warehouse or foreign trade zone.

This change of law has inadvertently encouraged importers to consider by-passing U.S. foreign trade zones where their product formerly was manipulated (i.e., inspected, tested, labeled, stamped, re-packed, etc.) and to accomplish these operations outside the United States. The result has been a loss of business and jobs in U.S. zones. In New York FTZ #1, 50 employees have been laid-off to date and unless the new law is changed, approximately 100 additional employees will be terminated by the end of the year.

The unintended result of this new law is peculiar to foreign trade zones because of the distribution network used for such articles, and because zones customarily do more than store distilled spirits, wine and beer. Section 3 of the Foreign Trade Zones Act authorizes these articles to be re-packed, assembled, distributed, sorted, graded, cleaned, broken-up, mixed with foreign or domestic merchandise, labeled, re-labeled, exhibited, or otherwise manipulated and be exported, destroyed, or sent into Customs territory of the United States.

Because of this authorization, foreign trade zones are distinctly different from customs bonded warehouses. Zones are more difficult to establish, they permit a wider range of operations and they create jobs. CBWs, on the other hand, are used for passive storage and warehouse operations and are the final distribution point for products entering the U.S. market.

CBWs have not been affected by this change. Importers continue to make use of customs bonded warehouses, only now their product is more often transferred to a CBW from a foreign country, where manipulation occurs, rather than from a U.S. foreign trade zone.

Customs Bonded Warehouses cannot convert to a foreign trade zone. Foreign Trade Zone applicants must comply with a very detailed and prolonged application process (currently up to two years) and must have authority from their respective State legislature. Zones must be operated as public entities and be located at or near a U.S. Customs port of entry. Zone applicants must also have the consensus approval of the local community including the local elected officials, local governments, and economic development authorities. Finally, foreign trade zones must pay an annual U.S. Customs fee, much higher than that assessed a bonded warehouse, and must also satisfy strict Customs' security requirements.

Because of the manner in which imported spirits are distributed in the U.S., importers do not transfer their product from one customs bonded warehouse to another. Thus, the Customs Bonded Warehouse Association is not seeking the ability to ship "in-bond" from one CBW to another, but is supportive of the ability to transfer product from a FTZ to a single CBW.

On behalf of the National Association of Beverage Importers, we are writing to urge the members of the Committee on Ways and Means to restore prior law, permitting tax-free transfers of imported bottled distilled spirits, wine and beer from FTZs to CBWs. For the Committee's information enclosed is a brief memorandum explaining that the interest of the U.S. Government is more secure under a system that facilitates movement of such goods to CBWs where there must be a bond to protect the government's interest in the payment of any tariffs or duties. Also enclosed is the legislative history of the Foreign Trade Zone Act setting forth the purposes for which such facilities have been established. We hope this information is helpful in analyzing the merits of this proposed change.

Should you or your staff have any questions regarding this proposed change, please feel free to call me at 331-7760.

Sincerely yours,

Bill

William Morris

FOREIGN TRADE ZONES, CUSTOMS BONDED WAREHOUSES AND MANIPULATION AND STORAGE OF BOTTLED DISTILLED SPIRITS, WINES AND BEERS

The Foreign Trade Zones Act of 1934 established foreign-trade zones (FTZs) as isolated, enclosed and policed areas operated as public utilities, in or adjacent to a port of entry. The Act, as amended in 1950, authorizes foreign goods to be brought into FTZs to be stored, sold, exhibited, broken-up, repackaged, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise, or otherwise manipulated, or manufactured. These goods are not subject to U.S customs control or customs bond while in the zones. If the goods are for import into the U.S., the customs laws apply upon entry into customs territory (i.e. tariffs, duties, etc. become due and payable); if destined for export or destruction, the goods remain exempt from U.S. customs laws.

The legislative intent in establishing FTZs was to expedite and encourage foreign commerce. Exports from the U.S. of goods originating in foreign ports, stored and manipulated or manufactured in FTZs, are facilitated by not subjecting the goods to tariffs or duties. American businesses directly benefit from FTZs by lowering costs associated with the manufacture of products for export. FTZs also provide U.S. citizens with expanded employment opportunities by involving them in the manipulation and manufacturing of foreign goods performed in the zones. See A.T. Cross v. Sunil Trading, 467 F. Supp. 47, 50 (1979).

As a consequence of the changes made by the Budget Reconciliation Act of 1986 that treat FTZs and CBWs alike in the case of withdrawals of imported bottled distilled spirits, wines and beers, the advantage for American businesses of operating through FTZs is lost. In fact, to maintain the viability of the present business of labeling, sorting and repackaging of these products, such U.S. businesses must consider relocating outside the U.S. The Act renders impractical the transfer of such merchandise from FTZs to CBWs by making it a taxable event and accelerating the payment of customs duties and excise taxes. Consequently, where such goods have first been stored and manipulated in FTZs, U.S. beverage wholesalers are now unable to utilize CBWs that may be geographically remote from ports of entry, but close to retail markets.

Ironically, the U.S. government's interest is better protected by permitting the transfer of such goods from FTZs to CBWs since the goods stored in CBWs must be bonded in order to ensure the payment of any tariffs or duties.

the Housing and Community Development Act of 1974. The City of Boston shall retain such proceeds in a lump sum and shall be entitled to retain and use all past and future earnings from such proceeds, including any interest.

TITLE VIII—REVENUES, TRADE, AND RELATED PROGRAMS

Subtitle A—Revenue Provisions

PART I—INCREASES IN CERTAIN PENALTIES

SEC. 8001. INCREASE IN PENALTY FOR UNDERPAYMENTS OF TAX DEPOSITS.

(a) In General.—Subsection (a) of section 6656 of the Internal Revenue Code of 1954 (relating to underpayment of deposits) is amended by striking out "5 percent" and inserting in lieu thereof "10 percent".

(b) Effective Date.—The amendment made by subsection (a) shall apply to penalties assessed after the date of the enactment of this Act.

SEC. 8002. INCREASE IN PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF LIABILITY.

(a) In General.—Subsection (a) of section 6661 of the Internal Revenue Code of 1954 (relating to substantial understatement of liability) is amended to read as follows:

"(a) Addition to Tax.—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement."

(b) Effective Date.—The amendment made by subsection (a) shall apply to penalties assessed after the date of the enactment of this Act.

(c) Repeal of Increase in Penalty by Tax Reform Act of 1986.—Section 1504 of the Tax Reform Act of 1986 (relating to increase in penalty for substantial understatement of liability) is hereby repealed.

PART II—CERTAIN EXCISE TAX DEPOSITS ACCELERATED

SEC. 8011. CERTAIN EXCISE TAX DEPOSITS ACCELERATED.

(a) Tobacco.—

(1) In general.—Paragraph (2) of section 5703(b) of the Internal Revenue Code of 1954 (relating to method of payment of tax) is amended to read as follows:

"(2) Time for payment of taxes.—

"(A) In general.—Except as otherwise provided in this paragraph, in the case of taxes on tobacco products and cigarette papers and tubes removed during any semimonthly period under bond for deferred payment of tax, the last day for payment of such taxes shall be the 14th day after the last day of such semimonthly period.

"(B) Imported articles.—In the case of tobacco products and cigarette papers and tubes which are imported into the United States—

"(i) In general.—The last day for payment of tax shall be the 14th day after the date on which the article is entered into the customs territory of the United States.

"(ii) Special rule for entry for warehousing.—Except as provided in clause (iv), in the case of an entry for warehousing, the last day for payment of tax shall not be later than the 14th day after the date on which the article is removed from the 1st such warehouse.

"(iii) Foreign trade zones.—Except as provided in clause (iv) and in regulations prescribed by the Secretary, articles brought into a foreign trade zone shall, notwithstanding any other provision of law, be treated for purposes of this subsection as if such zone were a single customs warehouse.

"(iv) Exception for articles destined for export.—Clauses (ii) and (iii) shall not apply to any article which is shown to the satisfaction of the Secretary to be destined for export.

"(C) Tobacco products and cigarette papers and tubes brought into the United States from Puerto Rico.—In the case of tobacco products and cigarette papers and tubes which are brought into the United States from Puerto Rico, the last day for payment of tax shall be the 14th day after the date on which the article is brought into the United States.

"(D) Special rule where 14th day falls on Saturday, Sunday, or holiday.—*Notwithstanding* section 7503, if, but for this subparagraph, the due date under this paragraph would fall on a Saturday, Sunday, or a legal holiday (as defined in section 7503), such due date shall be the immediately preceding day which is not a Saturday, Sunday, or such a holiday."

(2) Technical amendment.—Subsection (c) of section 5704 of such Code (relating to tobacco products and cigarette papers and tubes released in bond from customs custody) is amended by striking out "to a manufacturer of tobacco products or cigarette papers and tubes or".

(b) Distilled Spirits, Wines, and Beer.—

(1) In general.—Subsection (d) of section 5061 of such Code (relating to method of collecting tax) is amended to read as follows:

"(d) Time for Collecting Tax on Distilled Spirits, Wines, and Beer.—

"(1) In general.—Except as otherwise provided in this subsection, in the case of distilled spirits, wines, and beer to which this part applies (other than subsection (b) of this section) which are withdrawn under bond for deferred payment of tax, the last day for payment of such tax shall be the 14th day after the last day of the semimonthly period during which the withdrawal occurs.

"(2) Imported articles.—In the case of distilled spirits, wines, and beer which are imported into the United States (other than in bulk containers)—

"(A) In general.—The last day for payment of tax shall be the 14th day after the date on which the article is entered into the customs territory of the United States.

"(B) Special rule for entry for warehousing.—Except as provided in subparagraph (D), in the case of an entry for warehousing, the last day for payment of tax shall not be later than the 14th day after the date on which the article is removed from the 1st such warehouse.

"(C) Foreign trade zones.—Except as provided in subparagraph (D) and in regulations prescribed by the Secretary, articles brought into a foreign trade zone shall, notwithstanding any other provision of law, be treated for purposes of this subsection as if such zone were a single customs warehouse.

"(D) Exception for articles destined for export.—Subparagraphs (B) and (C) shall not apply to any article which is shown to the satisfaction of the Secretary to be destined for export.

"(3) Distilled spirits, wines, and beer brought into the United States from Puerto Rico.—In the case of distilled spirits, wines, and beer which are brought into the United States (other than in bulk containers) from Puerto Rico, the last day for payment of tax shall be the 14th day after the date on which the article is brought into the United States.

"(4) Special rule where 14th day falls on Saturday, Sunday, or holiday.—Notwithstanding section 7503, if, but for this paragraph, the due date under this subsection for payment of tax would fall on a Saturday, Sunday, or a legal holiday (within the meaning of section 7503), such due date shall be the immediately preceding day which is not a Saturday, Sunday, or such a holiday."

(2) Technical amendment.—Paragraph (2) of section 5054(a) of such Code (relating to determination and collection of tax on beer) is amended by striking out all that follows "or," and inserting in lieu thereof "if entered for warehousing, at the time of removal from the 1st such warehouse".

(c) Effective Dates.—

(1) In general.—Except as provided in paragraph (2), the amendments made by this section shall apply to removals during semimonthly periods ending on or after December 31, 1986.

(2) Imported articles, etc.—Subparagraphs (B) and (C) of section 5703(b)(2) of the Internal Revenue Code of 1954 (as added by this section), paragraphs (2) and (3) of section 5061(d) of such Code (as amended by this section), and the amendments made by subsections (a)(2) and (b)(2) shall apply to articles imported, entered for warehousing, or brought into the United States or a foreign trade zone after December 15, 1986.

(3) Special rule for distilled spirits and tobacco for semimonthly period ending December 15, 1986.—With respect to remittances of—

(A) taxes imposed on distilled spirits by section 5001 or 7652 of such Code, and

(B) taxes imposed on tobacco products and cigarette papers and tubes by section 5701 or 7652 of such Code,

for the semimonthly period ending December 15, 1986, the last day for payment of such remittances shall be January 14, 1987.

Conference agreement

The conference agreement does not include the House bill provision.

5. ACCELERATED COLLECTION OF CERTAIN EXCISE TAXES

Present law

Excise taxes on alcohol and tobacco products are paid semimonthly, with payments being due the following number of days after each semimonthly period:

	Days
(a) domestically produced and bulk imported distilled spirits	30
(b) bottled imported distilled spirits	15
(c) beer and wine	15
(d) tobacco	25

In certain cases, payment of these excise taxes must be by means of electronic transfer of funds.

House bill

Under the House bill, payments of the excise taxes on tobacco, wine, and beer are due 14 days after the semimonthly period during which the products are removed from bonded premises. If the regular payment date falls on a Saturday, Sunday, or legal holiday, payment is due on the last preceding business day. The present-law rules requiring electronic transfer of funds in certain cases are retained.

This provision applies to taxable products removed during semimonthly periods ending on or after December 31, 1986. Under a special rule, tobacco excise taxes for the semimonthly period ending on December 145, 1986, will be due on January 14, 1986 (rather than January 10, 1986).

Senate amendment

The Senate amendment is the same as the House bill except that (1) no change is made to the present-law payment date for the excise taxes on wine and beer and (2) payments of the excise taxes on distilled spirits are due 14 days after the semimonthly period during which products are removed from bonded premises. (Bottled imported distilled spirits are taxed on removal from customs custody.)

The Senate amendment applies to taxes paid after September 30, 1986, for semimonthly periods ending on or after that date. Under a special rule, tobacco excise taxes for the semimonthly period ending on September 15, 1986, will be due on October 14, 1986.

Conference agreement

Under the conference agreement, the excise taxes on (a) domestically produced and bulk imported distilled spirits, (b) bottled imported distilled spirits, (c) beer and wine, and (d) tobacco products are due 14 days after the semimonthly period when the taxable event occurs (14 days after entry into the customs territory of the United States in the case of certain imported products). If the regular payment date falls on a Saturday, Sunday, or legal holiday, payment is due on the last preceding business day.

As under present law, the taxable event generally is removal from a bonded factory, distillery, winery, or brewery in the case of domestically produced taxable products and certain bulk imported products (i.e., distilled spirits). As stated above, the taxable event for other imported products is entry into the customs territory of the United States. A further exception is provided in the case of an entry pursuant to which taxable products are transferred directly to a customs' bonded warehouse ("CBW"). (A foreign trade zone is treated as a CBW for this purpose.) In such a case, the taxable event is removal from the first such CBW into which the products are placed upon entry into the United States. This rule does not apply, however, to any article so removed which is shown to the satisfaction of the Secretary to be destined for export. Finally, for taxable products brought into the United States from Puerto Rico, tax is due 14 days after the products are brought into the U.S.

The conference agreement retains the present-law requirements for payment of these taxes by electronic transfer of funds.

Effective date.—These provisions apply to products removed in semimonthly periods ending on or after December 31, 1986, and to products entered into the customs territory (including entry into a CBW) of the United States (or otherwise brought into the U.S.) after December 15, 1986.

Special rules are provided consolidating payments for the semimonthly periods ending on December 15, 1986, and December 31, 1986, in the case of distilled spirits and tobacco products that now receive more than 15 days after removal for payment of tax.

The Consolidated Omnibus Budget Reconciliation Act of 1986 imposed a manufacturers excise tax on smokeless tobacco, effective for taxable products removed from the factory after June 30, 1986. However, in June 1986, the Treasury Department incorrectly notified manufacturers of smokeless tobacco that the tax did not apply to products held at the factory on July 1, 1986, in a condition ready for sale to consumers. The conference agreement amends the effective date of the tax on smokeless tobacco to exempt otherwise taxable products held at the factory on July 1, 1986, in a condition ready for sale to ultimate consumers.

6. INCREASES IN CERTAIN TAX PENALTIES

A. PENALTY FOR FAILURE TO DEPOSIT TAXES

Present law

Employers and certain other taxpayers are required to make periodic deposits of various taxes (such as social security taxes or income taxes withheld from employees) prior to the close of the taxable year. Taxpayers who fail to comply with these deposit requirements may be subject to a penalty of five percent of any underdeposit not deposited on or before the prescribed date, unless it is shown that the failure is due to reasonable cause and not due to willful neglect (Code sec. 6656).

HOUSE CONFERENCE REPORT NO. 99-1012

* * * * *

[page 223]

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 5300) to provide for reconciliation pursuant to section 2 of the concurrent resolution on the budget for fiscal year 1987, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck out all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment which is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

TITLE I—AGRICULTURE PROGRAMS

(1) SALE OF NOTED AND OTHER OBLIGATIONS FROM THE RURAL DEVELOPMENT INSURANCE FUND

(a) The House bill provides that the Secretary of Agriculture must sell notes from the Rural Development Insurance Fund in such amounts as to realize net proceeds to the Government not less than—

(i) $552,000,000 during fiscal year 1988, and
(ii) $547,000,000 during fiscal year 1989. (Sec. 2001(a).)

The Senate amendment has the same terms, except that (i) it does not contain the words "to the Government" and (ii) the net proceeds to be realized from such sales must be not less than—

(A) $549,000,000 during fiscal year 1988, and
(B) $543,000,000 during fiscal year 1989. (Sec. 101(a).)

The Conference substitute adopts the House provision. (Sec. 1001(a).)

(b) The House bill provides that the Secretary of Agriculture must sell notes from the Rural Development Insurance Fund to realize the required net proceeds. (Secs. 2001(a) and (b).)

The Senate amendment is the same, except that it provides that the Secretary must sell notes and other obligations from the fund to realize the required savings. (Secs. 101 (a) and (b).)

The Conference substitute adopts the Senate provision. (Secs. 1001 (a) and (b).)

[page 224]

(c) The House bill provides that any sale of notes from the Rural Development Insurance Fund, as described above, cannot alter the terms specified in the note, except that, on sale, a note cannot be subject to the graduation requirements under section 333(c) of the Consolidated Farm and Rural Development Act. (Sec. 2001(c).)

(NOTE: Section 333(c) of the Consolidated Farm and Rural Development Act provides that the Secretary of Agriculture can require a borrower to agree to obtain financing from private or cooperative sources and to pay off the loan from the Rural Development Insurance Fund if it appears to the Secretary that the borrower is able to obtain a loan from such sources. (7 U.S.C. 1983(c).))

The Senate amendment contains no comparable provision.

The Conference substitute adopts the House provision. (Sec. 1001(c).)

(d) The House bill provides that private parties wishing to purchase notes from the Rural Development Insurance Fund must demonstrate an ability to service (or provide resources for servicing) the loans represented by the notes, including the ability to provide technical assistance, additional credit, and any other services that the Secretary of Agriculture deems are necessary to ensure continued performance on the loan. (Sec. 2001(f).)

The Senate amendment contains no comparable provision.

The Conference substitute adopts the House provision with an amendment specifying that any private party wishing to purchase notes from the Rural Development Insurance Fund must demonstrate the ability to service (or provide resources for servicing) loans represented by the notes, including the ability to provide services (or to obtain the resources to provide such services) that the Secretary deems are necessary to ensure continued performance on the loans, and the ability to generate capital for additional needed credit. (Sec. 1001(e).)

The conferees intend that loans that are sold from the Rural Development Insurance Fund continued to be adequately serviced. Moreover, purchasers of notes should be authorized to conduct loan servicing directly, or indirectly through other arrangements. At the same time, servicing requirements imposed by the Secretary should not unreasonably reduce the marketability or value of the notes to be sold.

Purchasers of notes from the Rural Development Insurance Fund must service such loans or provide for such servicing in a manner that will ensure the borrower's continued performance on the note. The statutory language is not intended, however, to force buyers to take unreasonable steps to guarantee performance or to otherwise preclude the possibility of foreclosure.

The conferees intend that the Secretary, acting through the Farmers Home Administration (FmHA), ensure that technical assistance as currently available to FmHA borrowers remain available to those Rural Development Insurance Fund borrowers whose loans have been sold from the Fund. The Farmers Home Administration must provide such technical assistance if it is not otherwise provided to the borrower.

The conferees also intend that any regulations issued to implement the servicing of notes not substantially reduce the pool of potential purchasers. An environment should be established in which

BUFFALO RAPIDS WATER CONSERVATION AND UTILIZATION PROJECT, MONTANA—BUILDINGS AND IMPROVEMENTS

CHAPTER 295—PUBLIC LAW 565

[H. R. 829]

An Act to authorize the Secretary of Agriculture to accept buildings and improvements constructed and affected by the Buffalo Rapids Farms Association on project lands in the Buffalo Rapids water conservation and utilization project and canceling certain indebtedness of the association, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That:

The Secretary of Agriculture is hereby authorized and directed, within one year from the date of this Act, to accept, on behalf of the United States, the interest of the Buffalo Rapids Farms Association, a Montana corporation, hereinafter referred to as the association, in all buildings, structures, improvements or alterations therein, constructed, erected, placed, or made by the association on project lands in the Buffalo Rapids water conservation and utilization projects, divisions I and II, hereinafter referred to as the project, situated in the State of Montana and established pursuant to the provisions of the item "Water Conservation and Utility Projects" in the Interior Department Appropriation Act, 1940 (53 Stat. 685, 719), and designated a project under the Act of August 11, 1939, as amended (16 U.S.C. (and Supp.) 590y–590z–11),[6] as provided therein, and, upon the acceptance thereof, the then unpaid balance of the obligations of the association, including unpaid accrued interest, under mortgage notes dated January 19, 1942, March 31, 1942, April 9, 1942, and October 27, 1942, originally in the total amount of $220,000, executed by the association and delivered to the United States pursuant to loan contract numbered A–10–FSA–382–PC–MT–104, dated December 4, 1941, between the association and the United States, shall be deemed to have been fully paid and satisfied, and said buildings, structures, improvements, or alterations therein shall be administered and disposed of by the Secretary of Agriculture as part of the project, in the same manner as though acquired with project lands under the provisions of Section 5 (a) of the Act of August 11, 1939, as amendud (16 U.S.C. 590z–3(a)).[7]

Approved June 17, 1950.

FOREIGN TRADE ZONES—ADMISSION OF FOREIGN MERCHANDISE

See Legislative History, p. 2533

CHAPTER 296—PUBLIC LAW 566

[H. R. 5332]

An Act to amend section 3 of the Act of June 18, 1934, relating to the establishment of foreign-trade zones.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That:

Section 3 of the Act of June 18, 1934 (Public Law Numbered 397, Seventy-third Congress; 48 Stat. 998),[8] relating to the establishment of foreign-trade zones, is amended to read as follows:

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[6] 16 U.S.C.A. §§ 590y to 590z–11.

[7] 16 U.S.C.A. § 590z–3(a).

[8] 19 U.S.C.A. § 81c.

"Sec. 3. Foreign and domestic merchandise of every description, except such as is prohibited by law, may, without being subject to the customs laws of the United States, except as otherwise provided in this Act, be brought into a zone and may be stored, sold, exhibited, broken up, repacked, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise, or otherwise manipulated, or be manufactured except as otherwise provided in this Act, and be exported, destroyed, or sent into customs territory of the United States therefrom, in the original package or otherwise; but when foreign merchandise is so sent from a zone into customs territory of the United States it shall be subject to the laws and regulations of the United States affecting imported merchandise: *Provided*, That whenever the privilege shall be requested and there has been no manipulation or manufacture effecting a change in tariff classification, the collector of customs shall take under supervision any lot or part of a lot of foreign merchandise in a zone, cause it to be appraised and taxes determined and duties liquidated thereon. Merchandise so taken under supervision may be stored, manipulated, or manufactured under the supervision and regulations prescribed by the Secretary of the Treasury, and whether mixed or manufactured with domestic merchandise or not may, under regulations prescribed by the Secretary of the Treasury, be exported or destroyed, or may be sent into customs territory upon the payment of such liquidated duties and determined taxes thereon. If merchandise so taken under supervision has been manipulated or manufactured, such duties and taxes shall be payable on the quantity of such foreign merchandise used in the manipulation or manufacture of the entered article. Allowance shall be made for recoverable and irrecoverable waste; and if recoverable waste is sent into customs territory, it shall be dutiable and taxable in its condition and quantity and at its weight at the time of entry. Where two or more products result from the manipulation or manufacture of merchandise in a zone the liquidated duties and determined taxes shall be distributed to the several products in accordance with their relative value at the time of separation with due allowance for waste as provided for above: *Provided further*, That subject to such regulations respecting identity and the safeguarding of the revenue as the Secretary of the Treasury may deem necessary, articles, the growth, product, or manufacture of the United States, on which all internal-revenue taxes have been paid, if subject thereto, and articles previously imported on which duty and/or tax has been paid, or which have been admitted free of duty and tax, may be taken into a zone from the customs territory of the United States, placed under the supervision of the collector, and whether or not they have been combined with or made part, while in such zone, of other articles, may be brought back thereto free of quotas, duty, or tax: *Provided further*, That if in the opinion of the Secretary of the Treasury their identity has been lost, such articles not entitled to free entry by reason of noncompliance with the requirements made hereunder by the Secretary of the Treasury shall be treated when they reenter customs territory of the United States as foreign merchandise under the provisions of the tariff and internal-revenue laws in force at that time: *Provided further*, That under the rules and regulations of the controlling Federal agencies, articles which have been taken into a zone from customs territory for the sole purpose of exportation, destruction (except destruction of distilled spirits, wines, and fermented malt liquors), or storage shall be considered to be exported for the purpose of—

"(a) the draw-back, warehousing, and bonding, or any other provisions of the Tariff Act of 1930, as amended, and the regulations thereunder; and

"(b) the statutes and bonds exacted for the payment of draw-back, refund, or exemption from liability for internal-revenue taxes and for the purposes of the internal-revenue laws generally and the regulations thereunder.

Such a transfer may also be considered an exportation for the purposes of other Federal laws insofar as Federal agencies charged with the enforcement of those laws deem it advisable. Such articles may not be returned to customs territory for domestic consumption except where the Foreign-Trade Zones Board deems such return to be in the public interest, in which event the articles shall be subject to the provisions of paragraph 1615 (f) of the Tariff Act of 1930, as amended[9]: *Provided further*, That no operation involving any foreign or domestic merchandise brought into a zone which operation would be subject to any provision or provisions of section 1807, chapter 15, chapter 16, chapter 17, chapter 21, chapter 23, chapter 24, chapter 25, chapter 26, or chapter 32 of the Internal Revenue Code[10] if performed in customs territory, or involving the manufacture of any article provided for in paragraph 367 or paragraph 368 of the Tariff Act of 1930,[11] shall be permitted in a zone except those operations (other than rectification of distilled spirits and wines, or the manufacture or production of alcoholic products unfit for beverage purposes) which were permissible under this Act prior to July 1, 1949: *Provided further*, That articles produced or manufactured in a zone and exported therefrom shall on subsequent importation into the customs territory of the United States be subject to the import laws applicable to like articles manufactured in a foreign country, except that articles produced or manufactured in a zone exclusively with the use of domestic merchandise, the identity of which has been maintained in accordance with the second proviso of this section, may, on such importation, be entered as American goods returned."

SEC. 2. IMPORT DUTY REMOVED FROM EVERGREEN CHRISTMAS TREES

(a) Paragraph 1803 of the Tariff Act of 1930[12] is amended by adding at the end thereof the following new subparagraph:

"(3) Evergreen Christmas trees."

(b) This section shall be effective as to articles entered for consumption or withdrawn from warehouse for consumption on or after the first day of the first month which begins more than ten days after the date of enactment of this Act.

Approved June 17, 1950.

WINGATE ORDNANCE DEPOT, NEW MEXICO—SURPLUS PROPERTY—USE BY BUREAU OF INDIAN AFFAIRS

CHAPTER 320—PUBLIC LAW 567

[H. R. 5556]

An Act to make available for Indian use certain surplus property at the Wingate Ordnance Depot, New Mexico.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That:

The Secretary of the Army is hereby authorized and directed to transfer to the Department of the Interior, for use by the Bureau of Indian Affairs, that portion of the Fort Wingate Military Reservation, New Mexico, comprising approximately thirteen thousand one hundred and fifty acres, heretofore determined to be surplus to the requirements of the Department of the Army. Title to the land so transferred shall remain in the United States for the use of the Bureau of Indian Affairs.

Sec. 2. All contractual rights and all property, right, title, and interest of the United States in and with respect to structures and improvements in Veterans Temporary Housing Project NM-VN-29166, located on land of the Navajo Tribe of Indians, and known as Wingate Navajo Village, Gallup, New Mexico, are hereby relinquished and transferred to the Navajo Tribe of Indians. After the date of enactment of this Act, the provisions of the Act entitled "An Act to expedite the provision of housing in con-

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[9] 19 U.S.C.A. § 1201, par. 1615(f).

[10] 26 U.S.C.A.

[11] 19 U.S.C.A. § 1001, pars. 367, 368.

[12] 19 U.S.C.A. § 1001, par. 1803.

FOREIGN TRADE ZONES—ADMISSION OF FOREIGN MERCHANDISE

For text of Act see p. 249

Senate Report No. 1107, Sept. 26, 1949 [To accompany H.R. 5332]

House Report No. 957, June 30, 1949 [To accompany H.R. 5332]

The Senate Report repeats in substance the House Report.

Senate Report No. 1107

THE Committee on Finance, to whom was referred the bill (H. R. 5332) to amend section 3 of the act of June 18, 1934, relating to the establishment of foreign-trade zones, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

H. R. 5332 as it passed the House related to the establishment of foreign-trade zones. Your committee has approved this provision and added another section which is intended to encourage the development of new domestic sources of zinc ores.

Since no change was made in the provision relating to the establishment of foreign-trade zones, the report filed by the Committee on Ways and Means is adopted as your committee's views on section 1 of the bill as reported to the Senate.

SECTION 1. ESTABLISHMENT OF FOREIGN-TRADE ZONES

PURPOSE

Under existing law manufacturing and exhibiting within a foreign-trade zone are expressly prohibited. This section would permit manufacturing and exhibiting within a zone and would (with certain exceptions), under proper regulations, enable articles entering a foreign-trade zone from customs territory solely for export, destruction, or storage to be treated as exported for such purposes as draw-back, warehousing, and bonding provisions of the tariff laws, or for exemption from liability for internal-revenue taxes.

GENERAL STATEMENT

A foreign-trade zone is an isolated, fenced off, and policed are within or adjacent to a port of entry where foreign merchandise may b landed, stored, repacked, sorted, mixed or otherwise manipulated with minimum of customs control and without customs bond. If such merchandise is brought into customs territory, it is subject to all customs law and regulations.

Under the act of June 18, 1934, the Foreign-Trade Zones Board, composed of the Secretary of Commerce, Secretary of the Treasury, an Secretary of War, is authorized to grant to public and private co porations the privilege of establishing, operating, and maintaining foreig trade zones for the purpose of expediting and encouraging foreign cor merce. The Foreign-Trade Zones Board also has responsibility for administration of the law governing the operation of such zones.

Grants have now been issued for the establishment and operation of a foreign-trade zone at Staten Island, N. Y.; New Orleans; San Francisco; Los Angeles; and Seattle. An application for a foreign-trade zone at San Antonio is now pending. Interest in the establishment of a foreign-trade zone at inland ports of entry has developed because of the potential stimulus to air commerce.

The Secretary of Commerce advised the Committee on Ways and Means in a letter addressed to the chairman dated March 18, 1949, in part, as follows:

> The existence of the present trade zones has done much to stimulate American commerce both import and export. The proposed permission of manufacturing in the zones is expected further to assist American business by enabling it to manufacture certain types of products for export under minimum cost conditions.
>
> With respect to the exhibition of goods within the foreign-trade zones, the present law permits the examination and sampling of merchandise, but does not allow the maintenance of display counters. It is the Department's opinion that such a distinction is unwarranted and that the full exhibiting of goods should be allowed. From a trade-promotion viewpoint, this added activity would be highly desirable and essential. Both foreign and American goods would be on display. Trade zones could be used as modified international trade fairs where foreign merchants and manufacturers would display their goods for sale to importers and domestic retailers, and domestic goods would be exhibited in an effort to attract foreign buyers and encourage their purchase of American goods.

The Department of State, in reporting favorably on similar legislation, stated:

> It is believed that expansion of the scope of activity of the free-trade zones, as proposed in this draft legislation, would contribute to expansion of international trade, which this Government has long advocated as general policy through the trade-agreements program and more recently in the establishment of the International Monetary Fund, the conclusion of the general agreement on tariffs and trade, and in the drafting of a charter for an International Trade Organization. Provision of increased facilities for conduct of trade as here proposed would help many countries to achieve more effective use of productive resources and higher living standards.

Safeguards satisfactory to the Treasury Department have been included in this section to insure the collection of the revenues.

Furthermore, the House Special Committee on Postwar Economic Policy and Planning in the Seventy-ninth Congress recommended as follows:

> Our foreign trade would be further assisted by the creation of additional foreign-trade zones. * * * In each of these zones, the importation of goods for the purpose of display, sampling, or manufacture for reexport should be permitted free of duty. This would avoid extra handling and freight charges, and would eliminate draw-backs on such goods.

EXPLANATION OF SECTION 1

This section amends the existing provisions of section 3 of the act of June 18, 1934 (Public Law 397, 73d Cong., 48 Stat. 998), relating to the establishment of foreign-trade zones, and adds three new provisos to section 3. As so amended, section 3 would remove the prohibition against, and would specifically authorize, manufacture and exhibition within a zone. In a letter from the International Trade Committee of the Illinois Manufacturers Association, support of this section was expressed with respect to permitting manufacturing within a foreign-trade zone. Specific authorization that merchandise brought into a zone may be sold or destroyed would clarify existing law, under which sale or destruction of merchandise in a zone has been permitted. Retail sales, however, would continue to be limited by section 15(d) of the act of June 18, 1934.

The extent to which manufacture or other activities could be carried on in a zone would also be limited by a new fifth proviso, that no operation involving any foreign or domestic merchandise brought into a zone, which operation would be subject to any provision or provisions of section 1807 (tax on playing cards), chapter 15 (taxes on tobacco, snuff, cigars, and cigarettes), chapter 16 (taxes on oleomargarine, adulterated butter, and process or renovated butter), chapter 17 (tax on filled cheese), chapter 21 (taxes on coconut and other vegetable oils), chapter 23 (taxes on narcotics), chapter 24 (tax on white phosphorous matches), chapter 25 (taxes on firearms), chapter 26 (tax on liquor), or chapter 32 (tax on sugar) of the Internal Revenue Code, if performed in customs territory, shall be permitted in a zone. Except for rectification of distilled spirits and wines, and the manufacture or production of alcoholic products unfit for beverage purposes, however, the fifth proviso would not prohibit operations which are permissible within a foreign-trade zone under existing law.

The first proviso to section 3 of the act of June 18, 1934, now authorizes the appraisement and liquidation of duties on foreign merchandise when it is first admitted to a zone, such duties not to be paid until the merchandise is sent into customs territory. This privilege has not been used by importers, possibly because the proviso also imposes an absolute requirement that the duties be paid within a maximum of 2 years, even if the merchandise is never sent into customs territory. The proposed legislation would modify this proviso in several respects. The importer could secure a finding of the taxes as well as the duties on his merchandise. This finding could be requested either when the foreign merchandise first entered a zone or at any time during its stay in the zone unless and until there was a manipulation or manufacture effecting a change in tariff classification of the merchandise. The proposed legislation would authorize such a finding of taxes and duties only once and a finding, once made, would thereafter govern the dutiable and taxable status of the merchandise whenever it was sent into customs territory, whether or not it had been manipulated or manufactured in the zone in the meantime. The present absolute requirement for payment of duties on merchandise obtaining a privileged status under the proviso would be eliminated. Duties and taxes would be payable in accordance with the finding only if and when the merchandise was sent into customs territory. The amended proviso would not authorize consumption of merchandise in a zone, but would authorize its exportation or destruction without the payment of the liquidated duties and determined taxes thereon.

Under the amended proviso, if foreign merchandise taken under supervision for the liquidation of duties and determination of taxes thereon is subsequently manipulated or manufactured, such duties and taxes would be payable on the quantity of such foreign merchandise used in the manipulation or manufacture of the article later sent into customs territory. Allowance would be made for recoverable and irrecoverable waste; and if recoverable waste were sent into customs territory, it would be dutiable and taxable in its condition and quantity, and at its weight at the time of entry. Where two or more products resulted from the manipulation or manufacture of such merchandise the liquidated duties and termined taxes would be distributed to the several products in accordance with their relative value at the time of separation, with due allowance for waste as indicated above.

Under the second proviso of section 3 of the act, articles, the growth, product, or manufacture of the United States, and articles previously imported on which duty has been paid or which have been admitted free of duty, subject to regulations of the Secretary of the Treasury respecting identity and the safeguarding of the revenue, may be taken into a zone from customs territory and may subsequently be brought back to customs territory free of duty. This section would expressly extend this proviso to authorize the return of such merchandise to customs territory without regard for quota restrictions, since under existing law it is not clear whether merchandise sent from customs territory to a zone and later brought back into customs territory is subject to quotas. The second proviso would also be made specifically applicable to articles on which all internal-revenue taxes have been paid if subject thereto.

The third proviso of section 3 of the act presently reads as follows:

> *Provided*, That if in the opinion of the Secretary of the Treasury their identity has *not* been lost such articles not entitled to free entry by reason of noncompliance with the requirements made hereunder by the Secretary of the Treasury shall be treated when they reenter the customs territory of the United States as foreign merchandise under the provisions of the tariff laws in force at that time.

The insertion of the word "not" in the original act appears to have been a mistake and would therefore be deleted by this section in order to conform the language with the apparent original intent of Congress.

This section would add to section 3 of the act a new fourth proviso that under the rules and regulations of the controlling Federal agencies articles taken into a zone from customs territory for the sole purpose of exportation, destruction (except destruction of distilled spirits, wines, and fermented malt liquors), or storage would be considered to be exported for the purpose of certain Federal laws. The proviso specifically covers the draw-back, warehousing, and bonding, or any other provisions of the Tariff Act of 1930, as amended, and the regulations thereunder. Therefore a transfer of an article from customs territory to a zone for any of the authorized purposes would be considered the equivalent of exportation so far as any provision of the tariff act is concerned. Articles manufactured in customs territory with the use of imported duty-paid materials could be transferred to a zone and draw-back of duties would thereupon become payable without actual exportation. Imported merchandise in customs bonded warehouse, or otherwise under customs bond could be transferred to a zone and liability under the bonds extinguished to the same extent, and subject to all other requirements and regulations, as if actually exported. "

This proviso also applies similarly to internal-revenue taxes. Under rules and regulations of the Federal agency in charge of the administration and enforcement of the internal-revenue laws articles taken into a zone from customs territory for the sole purpose of exportation, destruction (except destruction of distilled spirits, wines, and fermented malt liquors), or storage would be considered exported for the purpose of the statutes and bonds exacted for the payment of draw-back, refund or exemption from liability for internal-revenue taxes and for the purposes of the internal-revenue laws generally and the regulations thereunder.

The benefits of the fourth proviso would be limited specifically to articles taken into a zone for exportation, destruction, or storage, and would not apply to articles taken into a zone for consumption, or with the intent of eventual reentry into customs territory. The benefits would not extend to articles taken into a zone for manipulation or manufacture prior to exportation. The proviso would furnish relief for manufacturers and other business interests whose merchandise is destined eventually for export use but which merchandise, for one reason or another, cannot practicably be exported immediately. In such cases the proviso would authorize refund by way of draw-back of duties and taxes while the merchandise remained in a zone awaiting actual exportation, and would also relieve the interested parties from expense and liability of customs and internal-revenue bonds. Imported merchandise which had been stored in a customs bonded warehouse for almost the full statutory time limit of 3 years could, under the provision, be transferred to a zone for further storage pending actual exportation. Another use of the proviso might be the encouragement of the establishment in foreign-trade zones of world markets for various commodities.

Articles receiving the benefits of the proviso could be shipped in bond through customs territory in process of exportation, but could not be returned from the zone to customs territory for domestic consumption except where the Foreign-Trade Zones Board deemed such return to be in the public interest, in which event the articles would be subject to a duty equal to the duty and tax from which they had previously been relieved, in accordance with the provisions of paragraph 1615 (f) of the Tariff Act of 1930, as amended.

The fourth proviso under discussion would also authorize a transfer of articles from customs territory to a zone for the specified purposes to be considered an exportation for the purposes of other Federal laws insofar as Federal agencies charged with the enforcement of those laws deemed it advisable. Federal agencies dealing with such matters as pure food and drugs, export licensing or control of exportation of munitions would not be required to treat the transfer to articles from customs territory to a zone as the equivalent of exportation for purposes of the laws which they administer, but such agencies would be authorized to treat those transfers to a zone as equivalent to exportation insofar as they deemed it consistent with the provisions and purposes of those laws.

This section would also add a new sixth proviso to clarify the duty and tax status of articles which, after having been produced or manufactured in a zone and exported to a foreign country, are subsequently imported into customs territory of the United States. The proviso would make such articles dutiable and taxable as if manufactured in a foreign country. There is an exception, however, which would permit the free entry as American goods returned of any articles which had been produced or manufactured in a zone exclusively with the use of privileged domestic merchandise, that is, merchandise upon which the duty and tax, if any, had already been paid and the identity of which had been maintained in accordance with the second proviso to section 3 of the act.

SECTION 2. DEVELOPMENT OF NEW DOMESTIC SOURCES OF ZINC ORES

Section 2 of the bill, effective 30 days after the date of enactment, exempts from duty zinc in blocks, pigs or slabs, when imported after having been recovered abroad from zinc concentrates produced in the United States. In order to obtain the advantage set forth in the proposed legislation, the zinc products named must be entered, or withdrawn from warehouse, for the account of the exporter of the zinc concentrates within 60 days after exportation took place; furthermore, the quantity of the specified zinc products entitled to free entry is limited to not more than 85 percent of the weight of the zinc content of concentrates exported.

It appears that in northeast Washington there are a number of zinc mines, and more than 200 separate properties now known to show substantial occurrences of zinc; but there are no nearby available United States smelters. The nearest smelters within continental limits of this country are from 200 to 400 miles away. In fact these are already fully supplied with concentrates produced in their own nearby area; and thus these smelters are not particularly interested in handling concentrates of the grade produced by the independently owned mines in northeastern

Code of Federal Regulations

Admission, etc., of merchandise into zones, see 19 CFR 146.0 et seq.
Exportation of,
  Cigars, etc., see 27 CFR 290.1 et seq.
  Liquors, see 27 CFR 252.1 et seq.
Foreign Trade Zones Board, jurisdiction, powers, etc., see 15 CFR 400.100 et seq.

Notes of Decisions

1. Purpose

This chapter is demonstrably intended to protect competitive interest of entire class of domestic steel producers. Armco Steel Corp. v. Stans, C.A.N.Y.1970, 431 F.2d 779.

The purpose of this chapter, is to expedite and encourage foreign commerce. New York Foreign Trade Zone Operators v. State Liquor Authority, 1941, [illegible] N.E.2d 316, 285 N.Y. 272.

§ 81b. Establishment of zones

Board authorization to grant zones

(a) The Board is authorized, subject to the conditions and restrictions of this chapter and of the rules and regulations made thereunder, upon application as hereinafter provided, to grant to corporations the privilege of establishing, operating, and maintaining foreign-trade zones in or adjacent to ports of entry under the jurisdiction of the United States.

Number of zones per port of entry

(b) Each port of entry shall be entitled to at least one zone, but when a port of entry is located within the confines of more than one State such port of entry shall be entitled to a zone in each of such States, and when two cities separated by water are embraced in one port of entry, a zone may be authorized in each of said cities or in territory adjacent thereto. Zones in addition to those to which a port of entry is entitled shall be authorized only if the Board finds that existing or authorized zones will not adequately serve the convenience of commerce.

Preference to public corporations

(c) In granting applications preference shall be given to public corporations.

Ownership of harbor facilities by State

(d) In case of any State in which harbor facilities of any port of entry are owned and controlled by the State and in which State harbor facilities of any other port of entry are owned and controlled by a municipality, the Board shall not grant an application by any public corporation for the establishment of any zone in such State, unless such application has been authorized by an Act of the legislature of such State (enacted after June 18, 1934).

June 18, 1934, c. 590, § 2, 48 Stat. 999.

Library References

Customs Duties ⚿22.1. C.J.S. Customs Duties §§ 22, 30.

Notes of Decisions

Hearing 3
Injunction 5
Jurisdiction 4
Power of Congress 2
Purpose 1

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1. Purpose

Purpose of foreign trade zones, created under this section permitting storage, exhibition, sale, and general dealing in regard to foreign commerce without subjecting it to United States Custom laws, is to expedite and encourage foreign commerce. Fountain v. New Orleans Public Service, Inc., C.A.La.1967, 387 F.2d 343.

Purpose of this section authorizing creation of foreign trade zones was to encourage and facilitate foreign commerce by the formation of areas in ports of entry wherein goods in foreign commerce might be stored within boundaries of United States or its territories without payment of custom duties, until and unless any of such goods passed from that zone into customs territory of the United States. Fountain v. New Orleans Public Service, Inc., D.C.La.1967, 265 F.Supp. 630.

2. Power of Congress

Free trade zone erected in Port of New York by State of New York under this chapter was created under exclusive and plenary power of Congress to regulate commerce with foreign nations, notwithstanding fact that zone was within geographical limits of State of New York, since State of New York had no power to subject goods in trade zone to local regulations. Dering v. Valente, 1944, [illegible] N.Y.S.2d [illegible], 267 App.Div. [illegible].

3. Hearing

Contrary to contention of plaintiff oil company that hearing afforded by Board, on third party's application seeking establishment of a primary foreign trade zone was violative of due process for reason that plaintiff was denied the right to cross-examine, record showed that plaintiff was afforded the right to cross-examine, and that such right was merely limited. Sinclair Oil Corp. v. Smith, D.C.N.Y.1968, 293 F.Supp. 1111.

4. Jurisdiction

Federal jurisdiction did not exist as to action for wrongful death which occurred when decedent, while employed by private concern, was electrocuted in United States trade zone created in New Orleans under this chapter, where this chapter did not confer jurisdiction on federal courts or relate to erection or maintenance of electrical devices, and zone was owned, operated, and maintained by Port of New Orleans Board of Commissioners. Fountain v. New Orleans Public Service, Inc., C.A.La.1967, 387 F.2d 343.

Plenary federal jurisdiction did not exist as to action for wrongful death which occurred when decedent, while employed by private concern, was electrocuted in United States trade zone in New Orleans, where cession of property from state to federal sovereign did not exist, and interstate or foreign commerce was not involved. Id.

Congress did not intend that federal courts would have jurisdiction over actions for damages for wrongful death arising under state statutes out of accidents occurring within a foreign trade zone, or indeed any matters save in the area of customs, which fall within constitutional authority of Congress to regulate foreign commerce and to provide for imposition of duties thereon. Fountain v. New Orleans Public Service, Inc., D.C.La.1967, 265 F.Supp. 630.

Assuming arguendo that phrase "under the jurisdiction of the United States", appearing in this section, referred to foreign trade zones, nothing in this chapter itself or in regulations promulgated thereunder indicated that federal jurisdiction would extend to any matters unrelated to custom duties or to the enforcement of federal laws and regulations concerning foreign commerce. Id.

Federal jurisdiction over wrongful death action arising out of accident which occurred in foreign trade zone could not be sustained on theory that state wrongful death statute became federal law as regards federal enclaves located within the state, where plaintiffs failed to allege, contend or suggest that the United States acquired, by lease, purchase or otherwise, any interest in territory comprising the foreign trade

Tax Equity and Fiscal Responsibility Act of 1982

SMITHKLINE BECKMAN CORPORATION COMMENTS ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

SmithKline Beckman Corporation respectfully submits to the Committee on Ways and Means the following comments regarding matters for inclusion in H.R. 2636, the Technical Corrections Act of 1987. The comments relate to an unintended inequity in the tax law that results in a significant double tax to SmithKline Beckman Corporation.

Legislative Background

The inequity described below originated as an oversight in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), as a result of amendments to section 936, which creates double taxation for SmithKline Beckman. The inequity was compounded by the Tax Reform Act of 1986 (the '86 Act) as a result of amendments to sections 482 and 936(h) which require income with respect to a transfer or license of intangible property to be commensurate with the income attributable to the intangible (the super royalty).

--Section 936(h) Cost Sharing

Section 936(h), enacted as part of TEFRA, deals with the tax treatment of intangible property income of possessions corporations and their shareholders. Under the TEFRA rules, a 936 company that elects cost sharing is required to make a cost sharing payment for use of intangibles developed or otherwise made available to it by its affiliates. The '86 Act required that the amount of the cost sharing payment be the greater of 110 percent of the cost sharing payment as required under TEFRA, or the payment which would be required if the electing corporation were a foreign corporation, i.e,. a royalty that is commensurate with the income attributable to the intangible. The cost sharing payment must be made to the electing corporation's U.S. affiliate, under the current interpretation of the section 936(h) cost sharing provisions, and is taxable in the U.S., even if the intangibles are discovered and owned by a foreign affiliate. No reduction is permitted for the royalties paid to affiliated foreign corporations. However, existing tax law (Sec. 936(h)(5)(C)(i)(I)) would permit a reduction in the cost sharing payment required to be made to the U.S. affiliate if the royalty were paid to an unrelated foreign company for use of intangible property discovered or owned by the foreign company.

--Section 482 Royalty Payments

In the subject circumstances, intangibles were created by a U.K. affiliate which licensed the intangibles to a possessions corporation. Under that agreement, the possessions corporation pays an arm's length royalty based on its sales of products manufactured under the licensed intangibles. Such a royalty is subject to review and approval by U.K. Inland Revenue, and is subject to being increased, on examination, in the same manner and for the same reasons that royalty payments by 936 corporations to their U.S. parent companies have been increased periodically by the Internal Revenue Service on examination. The royalty must be arm's length under standards similar to section 482.

Double Taxation

SmithKline Beckman's problem arises because the royalty which its possessions corporation pays to its U.K. affiliate is not deductible in computing its cost sharing payment under section 936(h). Thus, in effect, a double payment is made by the 936 company for the use of the same intangibles, with the royalty taxed by the foreign country and the cost sharing payment taxed by the U.S. In addition, under the '86 Act, the double tax result under TEFRA is further aggravated by the possibility of a double super royalty. Combined, the two super royalty payments with respect to the same intangibles could eliminate all of the profits of an electing (936) corporation under the cost sharing method.

The Super Royalty

The super royalty provisions generally provide that a related party royalty under section 482 as well as the cost sharing payment under section 936(h) must be commensurate with the income stream attributable to the transferred intangible. It should also be noted that the super royalty may also be used by foreign taxing authorities to determine an appropriate arm's length royalty from their perspective. For example, where the intangibles are discovered in the U.K., the U.K. Inland Revenue surely would feel that the U.K. taxpayer was entitled to the super royalty amount. Where both these payments must be made with regard to the same intangible property, the double application of the super royalty will result. This problem will not only affect SmithKline Beckman, but also other U.S. companies having products invented by foreign subsidiaries.

--Example of Double Taxation and Double Super Royalty

The following example is illustrative of the combined effect of the double tax and the double super royalty:

U.K. Co., an affiliate of U.S. Co., discovers product "A" through its own R&D efforts in the U.K. and registers a patent for product "A" around the world. U.K. Co. licenses 936 Co., a subsidiary of U.S. Co. to manufacture and sell product "A" and charges 936 Co. an arm's length royalty for use of its patent and other intangibles. 936 Co. has elected the cost sharing method under section 936 (h).

The unintended result under TEFRA which will be compounded by the '86 Act is as follows:

> Although product "A" was not discovered in the U.S., sales of product "A" manufactured in the possession will increase the cost sharing payment required to be made by 936 Co. to U.S. Co. each year, which payment is subject to U.S. income tax currently. Under the '86 Act the cost sharing payment will come under the super royalty provisions. The arm's length royalty paid by 936 Co. to U.K. Co. is also subject to U.K. income tax currently.
>
> The cost sharing payment made by 936 Co. covering the use of the same product "A" intangibles cannot be reduced by the royalty paid to U.K. Co. under the existing TEFRA rules Thus, the affiliated group has made payments for the use of the same intangibles to the U.K. and the U.S., both of which payments are taxed currently in the U.K. and the U.S.--a double tax.
>
> The '86 Act and the new super royalty rules apply both to the cost sharing payment made by 936 Co. to U.S. Co. and could also apply under the international application of the super royalty provisions to the royalty paid by 936 Co. to U.K. Co. Thus, a double super royalty.

Technical Correction

To be fully responsive to the double taxation problem, the technical correction must refer back to the effective date of TEFRA. The unintended double taxation problem as well as the double super royalty problem can be addressed through a technical correction that is simple to make. The correction would, in effect, recognize the arm's length royalty payment, as determined under section 482, to the foreign affiliate as a payment of cost sharing and permit that portion of the cost sharing payment to be made to the appropriate foreign affiliate. Specifically, this change would correct an unintended interpretation of section 936(h)(5)(C)(i)(IV)(a) to the effect that where there is any domestic member of the affiliated group to which a cost sharing payment can be made, then no payment can be made to a foreign member of the affiliated group. We believe that Congress did not intend a double tax result and, therefore, obviously intended a broader interpretation be given to the term "appropriate" in that subparagraph of the Code. Clearly, the tax impact on the electing corporation and its affiliates should be the same whether the royalty is paid to a related or an unrelated foreign company. We believe this to be an unintended oversight, when applied to the facts of SmithKline Beckman's situation, which results in the aforementioned double taxation.

--Suggested Language

The technical correction we are proposing can be effected by adding the following sentence at the end of the subparagraph (a) referred to above:

> Notwithstanding the preceding sentence, in the case of a payment by the electing corporation to a related party for a license from such related party, to the extent that such payment does not exceed an arm's length consideration under the principles of section 482, the amount paid as consideration shall be deemed not to be a royalty or other consideration for such license but shall be treated as a payment of cost sharing required under paragraph (IV) and shall reduce the amount otherwise payable to other members of the affiliated group.

--Limited Application of Technical Correction

The proposed technical correction would not be subject to abuse since (1) it would only apply where a foreign affiliate has in fact transferred or licensed intangible property to an electing (936) corporation and (2) it is limited by the arm's length standard of section 482, i.e., to situations where the royalty payment does not exceed the payment that unrelated parties dealing at arm's length would agree upon. Thus, the Internal Revenue Service would have a standard in its own regulations by which to measure the appropriateness of the royalty and, in the case of a country with which the U.S. has concluded an income tax treaty, an agreement could be reached with the foreign government's competent authority if a dispute arises. Additionally, the provision could be limited to application where the foreign affiliate is subject to a substantial income tax or only to countries which have income tax treaties with the U.S., or both.

--Revenue Effect

The proposed technical correction is believed to be revenue neutral because the double taxation result was never contemplated or intended by Congress and, therefore, no revenue could have attached to it.

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